DOMESTIC ENTITLEMENTS AND THE FEDERAL BUDGET

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COMMITTEE ON THE BUDGET

JIM NUSSLE, Iowa, *Chairman*

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DOMESTIC ENTITLEMENTS AND THE FEDERAL BUDGET

WEDNESDAY, FEBRUARY 15, 2006

HOUSE OF REPRESENTATIVES,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to call, at 2 p.m., in room 210, Cannon House Office Building, Hon. Jim Nussle (chairman of the committee) presiding.

Members present: Representatives Nussle, Crenshaw, Wicker, Garrett, Barrett, Diaz-Balart, Hensarling, Lungren, Bradley, Mack, Conaway, Chocola, Spratt, Moore, Neal, Baird, Cooper, Cuellar, Schwartz, and Kind.

Chairman NUSSLE. Good afternoon, and welcome, everyone. This is a full Committee on the Budget hearing on domestic entitlements and the Federal budget. We have before us today three distinguished witnesses, the Honorable David Walker, who is the Comptroller General of the Government Accountability Office (GAO). He is back for a command performance on this topic. This is—at least every year that I have been on this committee, General Walker, you have been here to talk about this very important issue. Some years we make a little bit more progress than others. But we welcome you back to this committee and for this topic.

We have the former Director of the Congressional Budget Office (CBO), and, sad to say, former Director Doug Holtz-Eakin did an excellent job, as far as I am concerned, on the committee. And I think that was something that was joined into with both a bipartisan—bipartisan comments upon your departure. And we welcome you back and miss your job that you did for us.

And finally, we have Dr. Isabel Sawhill. Dr. Sawhill is a senior fellow at the Brookings Institution, and we welcome you to the committee for this purpose.

As most of you all already know, this year has a particularly short window for holding hearings—we were just talking about that very issue up here at the rostrum—in order to provide us the information we need prior to the budget markup with only about 2 legislative weeks remaining before we have that task in front of us. I believe we have tried our best to make the most of our time and to do that by focusing our hearings on some pretty critical issues to our budget planning.

Today we are here to discuss what has necessarily become a regular hearing topic, as I said, the current status and outlook for our entitlement and, as we call them, mandatory spending or autopilot spending. Clearly we have not called this hearing today because we need someone to tell us we have a mandatory spending challenge ahead of us. That really had better not be news to any of us. But after intense debates that we have gone through this past year, really just to get our foot in the door on this problem, just to take that first step, if you will, in addressing what is arguably one of the most important challenges of this Congress from a spending standpoint—I thought it was wise for us to use the committee's time to have this conversation again. So we have before our committee today the distinguished witnesses for that purpose.

As I noted at last week's hearing on the President's budget request, our Nation's priorities have undergone certainly a major shift in the past several years. In addition to ongoing demands of critical domestic areas such as education, transportation, the environment, we could go on and on, we are now facing continuous threats of an international terrorism and growing pressures of inadequate domestic energy supplies. In addition, we continue to witness the unsustainable growth of a number of our government's largest and often the most important programs, and those are our mandatory entitlement programs.

All of these needs certainly place greater demands on an already stretched Federal budget, and it doesn't get any easier from here. Getting control of the budget requires that we understand and manage the ongoing shift in this balance of these priorities.

Last year we took another step in our long-term fiscal plan, a strategy to keep our economy growing strong, to create jobs, control spending across the board—and across the board in our budget—and continue our progress in reducing the deficit. Even as we adjusted for the challenges of the ongoing war and debilitating natural disasters, we have stuck with our fundamental plan, and we have done so for two reasons: First of all, because we believe in it; and second of all, because it is working. The economy last year grew at a robust 3.5 percent, and the forecasters estimate that future growth remains above 3 percent as we look forward into the future.

In January, payroll employment grew by 193,000 jobs. The unemployment rate dropped to 4.7 percent. We have created just in the last 3 years almost 5 million jobs, the lowest rate of unemployment at 4.7 percent in just these last 2 months, and that is the lowest since 9/11 as an example. We have had 29 consecutive months of job growth and 4.8 million new jobs created.

Because more people are working and earning more, they are certainly generating more in tax revenue—we know that. The Government took in about 15 percent more in revenue last year alone. This is happening as we maintain lower tax rates that were adopted in 2001 and 2003. We have also held our nonsecurity discretionary spending to a near freeze, tighter than last year's 1.3 percent growth, and a marked improvement from the 5-year average growth in our areas there in discretionary spending of a little over 6 percent. So we have made some progress there.

And just last week the President signed into law the Deficit Reduction Act of 2005, which begins a process that frankly should have started even sooner than that, and that is an annual look at reforming our most important programs to make sure that they are delivering a quality product at a low cost. It is the first time that we have done this in almost a decade, and in this process we have saved the taxpayers about $40 billion just in the next 5 years.

So we are making some progress, but we are not finished. We must keep the economy growing strong, but we will not grow out of this problem, as General Walker has told us, as Dr. Holtz-Eakin has told us, as we all, I think, will admit; we are not going to grow out of this problem. Growth is important, but it is not the end of the equation. We have to continue the work to restrain discretionary spending even as we respond to what is natural responses, whether it is the war, the hurricanes. But even as these things are critical, we must continue to meet this challenge of mandatory spending.

This spending is growing at about 6 percent per year, which is faster than our economy. That is faster than inflation, and far beyond our means to sustain it. And with the first baby boomers turning 60 this year, medical costs skyrocketing, and a steady decline of the number of workers for each retiree, the problem only gets worse as you look further down the road.

So these programs need to be reviewed not once every decade, but regularly. This should be a regular process. In fact, when we get out of that regular process, it becomes even more difficult to come back to it the way we did this last year.

Again, the Deficit Reduction Act was an important step, but it was not something that is going to fix this problem or this challenge with one stroke. As we begin to craft this year's budget, I believe we need to determine the best course to further our effort to reform and find savings in these very important programs.

And so, to that end, again, I welcome all of our witnesses. I am not expecting to find any particularly easy solutions today, or, for that matter, definite solutions. There are as many solutions as there are Members of Congress and as there are experts in the field. There are certainly many ways we can approach this. But I believe we need to set the commitment that we will continue a process to approach this on a regular basis.

So with that, let me turn it over to Mr. Spratt for any comments he would like to make. Welcome, Mr. Spratt.

Mr. SPRATT. First of all, to our distinguished panel, General Walker and Dr. Holtz-Eakin, and Dr. Sawhill, we have heard of the revolving door in Washington before, but this may be a record. We are delighted to have you here and hope that this is the beginning of a beautiful relationship. We look forward to working with you further in a different capacity.

Let me just echo to some extent what the chairman has just said and say that this kind of hearing is not only necessary to the process we are currently engaged in, but it should be a perennial as we bear down on this problem until we finally find solutions and get the results.

The aging of our population is something that we should in a sense celebrate, but it is also a burden to provide for. It is going to put unprecedented pressure on our health and our retirement systems. And we need to be looking for solutions now, not when the pressure comes to bear.

As you talk about long-term solutions today, I think you will all agree that you don't reach the long-term solutions until you deal with the short-term solution. As long as we are accumulating debt and stacking debt on top of debt, we are making it more and more difficult—not easier, but more and more difficult—to accommodate the demands that we know are coming for the widening wages of Medicare, Medicaid, and Social Security.

For example, if we were able to eradicate most of the debt we are incurring, get rid of the deficit we have got today, we could substantially reduce debt service's percentage of the total Federal budget, and that could be used to accommodate the 2 percentage points that will be necessary of GDP to take care of the solvency of Social Security in the future.

We also would like for you to comment, if you will, on the fact that while these are problems we have got in the Federal Government due to the fact that we are heavily invested in the health care sector. We have got two major health care entitlements and other, smaller entitlement programs that are significant as well, Veterans Administration, military health care, and Federal employees health care. All of these make the Federal Government far and away the largest purchaser, consumer of health care in our entire economy. But this reminds us that the problem that we are talking about today is not unique to Medicare or Medicaid or any of the other health care programs. It is part and parcel of the problem of health care in our entire society.

It is worth bearing in mind that last year the cost of Medicare and Medicaid went up by 6.8 to 6.9 percent respectively, which compares favorably with the cost last year, the cost increase last year, for private health insurance, which I understand was over 12 percent, 10 to 12 percent depending on the type of coverage you got. But we have a problem, but it is a social problem. It is a societal problem and affects all of these programs and not just Medicare and Medicaid. It affects those two because we are so heavily invested in them. But we would like your observations to about what to do about the overall social cost of these programs.

We welcome your presence here today, and look forward to hearing your testimony, and look forward to working with you in the future to obtain solutions to these clearly serious problems. And if you would also have any comments about process, because this is a case where process may have a lot to do with whether or not we reach a solution, we would welcome those comments as well.

Mr. WICKER. Gentlemen and lady, your written statements will, of course, be submitted for the record, without objection, and, I am told to begin left to right. So, General Walker, you are recognized first for any comments you might make in addition to those submitted into the record.

STATEMENTS OF DAVID M. WALKER, COMPTROLLER GENERAL, GOVERNMENT ACCOUNTABILITY OFFICE; DOUGLAS J. HOLTZ-EAKIN, Ph.D., FORMER DIRECTOR, CONGRESSIONAL BUDGET OFFICE; AND ISABEL V. SAWHILL, Ph.D., SENIOR FELLOW, THE BROOKINGS INSTITUTION

STATEMENT OF DAVID M. WALKER

Mr. WALKER. Thank you, Mr. Chairman, Ranking Member Spratt, other members of the committee. It is a pleasure to be back before the House Budget Committee.

Given the fact that my entire statement is included in the record, what I would like to do is with the assistance of the staff use PowerPoint to be able to make some points based upon the graphics that are contained within my statement. First one, please.

The first graphic demonstrates, among other things, that our Nation is on an imprudent and unsustainable fiscal path. The status quo is unacceptable and unsustainable. Economic growth will not solve our problem. Tough choices on spending and tax policies will be required, the sooner the better, because when you are a debtor, the miracle of compounding works against you rather than for you. (Figure 1.)

Mandatory spending reform, including entitlement reform, must be part of the overall equation looking forward.

This shows you past trends and future projections from CBO with regard to mandatory spending, discretionary spending and net interest costs. And as I said, the past cannot be prologue.

Next, please. I will show two long-range budget simulations by GAO, the latest ones we have done in January 2006. We rely upon our sister agency CBO for certain assumptions, but then we go out over a longer term than CBO's annual report. This is the first simulation I will show you, and it is based on CBO's baseline. (Figures 2 and 3.)

I will restate for the record, there are four assumptions that CBO is required to make by law that are not realistic, and, therefore, provide a misleading view about where we are headed. CBO does a good job, but there are certain constraints put on them.

First, no new laws will be passed, even if there is agreement on certain pieces of legislation. No. 2, discretionary spending will grow by the rate of inflation for 10 years. No. 3, all tax cuts will sunset as specified under current law. And No. 4, the alternative minimum tax will not be "fixed."

This shows under those assumptions—and I would respectfully suggest none of them are realistic, much less all of them—that we have a large and growing problem starting in 2015. (See Figure 1.) It is no wonder people say, don't worry about it, that is a long way off, I may not be here; there is a margin of error with the assumptions; or, don't worry, we will grow our way out of the problem.

The next one.

There are only two changes between this scenario and the last one. Discretionary spending grows by the rate of the economy, rather than the rate of inflation, for the first 10 years; and secondly, that all tax cuts are made permanent. I am not saying that is good, bad, or indifferent. That is just how the math works. And, by the way, this is not interest-rate-sensitive. (Figure 2.)

We know that over time, if we keep borrowing at the rates that we have been, we are going to have to start paying higher interest rates, and that will start a vicious cycle that ultimately every American will pay a price for.

Next, please.

This shows you how Social Security, Medicare, and Medicaid are projected to grow dramatically in the future years not just as a percentage of the budget, but as this shows, as a percentage of the economy. (Figure 4.)

To give you a sense: as of the end of fiscal 2005, which is, as you know, September 30, 2005, we would have had to have had $5.7 trillion invested at Treasury rates in order to deliver on the Social Security promises for the next 75 years. It is a bigger number for infinity, but 75 years is enough, $5.7 trillion invested at Treasury rates. We would have had to have about $30 trillion invested at Treasury rates to deliver on Medicare promises for the next 75 years, of which Medicare Part D is $8.7 trillion.

Next, please.

I think one of the things we have to keep in mind is that tax expenditures must be on the radar screen. They are currently largely off the radar screen. (Figure 5.)

We spend $700 to $800 billion a year on tax preferences. They are not in the financial statements of the U.S. Government, they are not part of the appropriations process, they are not part of the periodic reexamination that sometimes occurs on the spending side. But in many cases, what happens is tax preferences are back-door spending, and since there are no current PAYGO rules effective for tax expenditures or tax items, then sometimes people will try to achieve through the Tax Code what they are not able to achieve through direct spending. That has an adverse effect on the bottom line.

And so we need to look at both sides of the ledger. We are spending a lot of money here.

The fastest-growing tax preference is health care. And if you add not only the exclusion from income, but also the exclusion from payroll taxes, it was estimated that the cost of the health care tax preference to individuals was $178 billion last year and growing very rapidly.

Next, please.

We issued a report within the last month about possible options for looking at controlling mandatory spending. As you know, 61 percent of last year's budget was on autopilot, and it is going up every year. That is a combination of mandatory spending and interest, which I would argue is mandatory spending.

In our report we discussed the possibility of using triggers to force some type of action. There are two types of triggers. There are hard triggers where you automatically impose certain actions if the trigger is hit, and there are soft triggers where process would be invoked—which may or may not involve a commission, may or may not involve an agency like GAO or CBO or others—a process by which Congress would be provided certain information and would have to at least consider taking certain action in order to get us on a more prudent path. (Figure 6.)

Last, please.

I am sorry. There is one more after this.

Health care is the big problem. There are three things driving our long-range imbalance. No. 1, we have a situation where spending is growing very rapidly, especially on entitlement programs. We have demographic trends, and we have lower Federal revenues as a percentage of the economy than historically has been the case, and yet we haven't hit the tidal wave of the baby boom generation. (Figure 7.)

Mr. Spratt its exactly correct. Ultimately we are going to have to reform the entire health care system, but in installments over many years, because it is not only an issue at the Federal level, it is an issue at the State level. Medicaid is the fastest-growing cost for most States, and health care is also the single number one competitiveness challenge of U.S. business. It might take us 20 years to do it in installments, but we are going to have to do it. These are ideas for consideration by the Congress. One of the items that isn't on this list, but I think you need to think about, is revisiting Part D, $8.7 trillion, more than the entire debt of the United States outstanding since the beginning of the Republic, almost twice Social Security's unfunded balance.

And then last, the way forward for your consideration. Not everybody will like these, but I say the same thing everyplace I go. Reimpose budget controls on both sides of the ledger, on both the spending side and the tax side of the ledger. PAYGO rules. Discretionary spending caps, and mandatory spending triggers. We need to improve our accounting and reporting and other metrics with regard to financial statements, with regard to consideration of the long-term cost, affordability and sustainability of both spending proposals and tax proposals before legislation is enacted into law or before it is renewed. We need a set of key national indicators, safety, security, social, economic, environmental, to understand how we are trending, how we compare to other nations to assess which spending programs and tax policies are working, and which ones aren't, and which ones need to be reengineered or eliminated. (Figure 8.)

If the Members have not read this document, I respectfully request that you read it, and I have sent a copy to every Member on the Hill, and I will send you another one if you want.[1] It raises over 200 illustrative questions that need to be asked and answered about government. Our government is largely based on the 1950s and the 1960s, and we need to bring it into the 21st century, especially given the fiscal challenges we face.

And last, we are going to have to reform entitlement programs, reexamine the base of all spending, including mandatory spending, and review tax policy, all three, because the gap is too great to do it on even two of the three. We are going to have to do all three. I look forward to working with this committee and others in Congress to try to help do that in the coming years.

Thank you.

Mr. WICKER. Thank you very much, General Walker.

[The prepared statement of David M. Walker follows:]

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[1] GAO, *21st Century Challenges: Re-Examining the Base of the Federal Government,* GAO–05–325 SP (February 2005).

PREPARED STATEMENT OF HON. DAVID M. WALKER, COMPTROLLER GENERAL OF THE UNITED STATES

Mr. Chairman, Representative Spratt, and members of the committee, I appreciate this opportunity to talk with you about the need to look at entitlement and other mandatory spending programs in light of our nation's long-term fiscal outlook and the challenge it poses for the budget and oversight processes.

As I have said many times before, meeting our nation's large, growing, and structural fiscal imbalance will require a three-pronged approach:

- restructuring existing entitlement programs,
- reexamining the base of discretionary and other spending, and
- reviewing and revising existing tax policy, including tax expenditures,[1] which can operate like mandatory spending programs.

Before I turn to the major driver of the long-term spending outlook—rising health care costs combined with known demographic trends—I'd like to step back and take a broader view of the need to reexamine and reconsider what the Federal Government does, how it does it, and who does it. We are in the first decade of the 21st century but the basis and design for many of the Federal Government's activities date from before I was born.

In our report entitled 21st Century Challenges: Reexamining the Base of the Federal Government,[2] we presented illustrative questions for policy makers to consider as they carry out their responsibilities. These questions look across major areas of the budget and Federal operations including discretionary and mandatory spending, and tax policies and programs. We hope that this report, among other things, will be used by various congressional committees as they consider which areas of government need particular attention and reconsideration. You will, of course, also receive more specific proposals, some of them will be presented within comprehensive agendas—the President's Budget released last week is just one very prominent example.

Our report provides examples of the kinds of difficult choices the nation faces with regard to discretionary spending; mandatory spending, including entitlements; as well as tax policies and compliance activities. It is, I think, important to recognize that tax policies and programs financing the Federal budget can be reviewed not only with an eye toward the overall level of revenue provided to fund Federal operations and commitments, but also the mix of taxes and the extent to which the tax code is used to promote overall economic growth and broad-based societal objectives. In practice, some tax expenditures are very similar to mandatory spending programs even though they are not subject to the appropriations process or selected budget control mechanisms. As we reported last September, tax expenditures represent a significant commitment and are not typically subjected to review or reexamination.

Mandatory spending programs—like tax expenditures—are governed by eligibility rules and benefit formulas, which means that funds are spent as required to provide benefits to those who are eligible and wish to participate. Since Congress and the President must change substantive law to change the cost of these programs, they are relatively uncontrollable on an annual basis. Moreover, as we reported in a 1994 analysis, their cost cannot be controlled by the same "spending cap" mechanism used for discretionary spending.[3]

By their very nature mandatories limit budget flexibility.[4] As figure 1 shows, mandatory spending has grown as a share of the total Federal budget. For example, mandatory spending has grown from 27 percent before the creation of Medicare and Medicaid to 42 percent in 1985 to 54 percent last year. (Total spending not subject to annual appropriations—mandatory spending and net interest—has grown from 56 percent in 1985 to 61 percent last year.) Under both the Congressional Budget

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[1] Tax expenditures result in forgone revenue for the Federal Government due to preferential provisions in the tax code, such as exemptions and exclusions from taxation, deductions, credits, deferral of tax liability, and preferential tax rates. These tax expenditures are often aimed at policy goals similar to those of Federal spending programs; existing tax expenditures, for example, are intended to encourage economic development in disadvantaged areas, finance postsecondary education, and stimulate research and development. See GAO, Government Performance and Accountability: Tax Expenditures Represent a Substantial Federal Commitment and Need to Be Reexamined, GAO-05-690 (Washington, DC: Sept. 23, 2005).

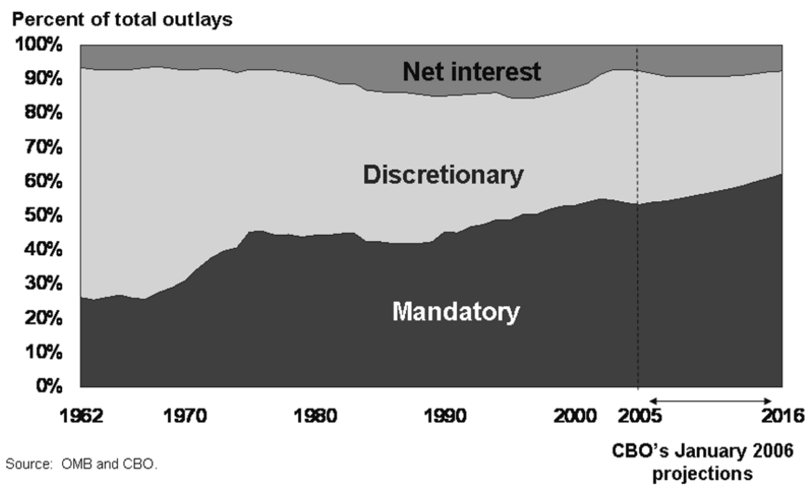
[2] GAO, 21st Century Challenges: Reexamining the Base of the Federal Government, GAO-05-325SP (Washington, DC: February 2005).

[3] GAO, Budget Policy: Issues in Capping Mandatory Spending, GAO/AIMD-94-155 (Washington, DC: July 18, 1994).

[4] Similarly tax expenditures may limit flexibility on the revenue side; there is a tradeoff between tax rates and revenue lost through tax expenditures. In order to raise a given amount of Federal revenue, tax rates must be raised higher than they otherwise need to be due to revenue losses from tax expenditures.

Office baseline estimates and the President's Budget, this spending would grow further.

FIGURE 1: FEDERAL SPENDING FOR MANDATORY AND DISCRETIONARY PROGRAMS



NOTE: Projections assume discretionary spending grows with inflation after 2006.

While the long-term fiscal outlook is driven by Medicare, Medicaid and Social Security, it does not mean that all other mandatory programs should be "given a pass." As we have noted elsewhere, reexamination of the "fit" between government programs and the needs and priorities of the nation should be an accepted practice.[5] So in terms of budget flexibility—the freedom of each Congress and President to allocate public resources—we cannot ignore mandatory spending programs even if they do not drive the aggregate.

While some might suggest that mandatory programs could be controlled by being converted to discretionary or annually appropriated programs, that seems unlikely to happen. If we look across the range of mandatories we see many programs have objectives and missions that contribute to the achievement of a range of broad-based and important public policy goals such as providing a floor of income security in retirement, fighting hunger, fostering higher education, and providing access to affordable health care. To these ends, these programs—and tax expenditures—were designed to provide benefits automatically to those who take the desired action or meet the specified eligibility criteria without subjecting them to an annual decision regarding spending or delay in the provision of benefits such a process might entail.

Although mandatory spending is not amenable to "caps," that does not mean that mandatory programs should be permitted to be on autopilot and grow to an unlimited extent. Since the spending for any given entitlement or other mandatory program is a function of the interaction between the eligibility rules and the benefit formula—either or both of which may incorporate exogenous factors such as economic downturns—the way to change the path of spending for any of these programs is to change those rules or formulas. We recently issued a report on "triggers"—some measure which, when reached or exceeded, would prompt a response connected to that program.[6] By identifying significant increases in the spending path of a mandatory program relatively early and acting to constrain it, Congress may avert much larger and potentially disruptive financial challenges and program changes in the future.

A trigger is a measure and a signal mechanism—like an alarm clock. It could trigger a "soft" response—one that calls attention to the growth rate or the level of spending and prompts special consideration when the threshold or target is breached. Two examples of soft responses that could be triggered include requiring the relevant agency to prepare a report analyzing why the trigger was tripped and/

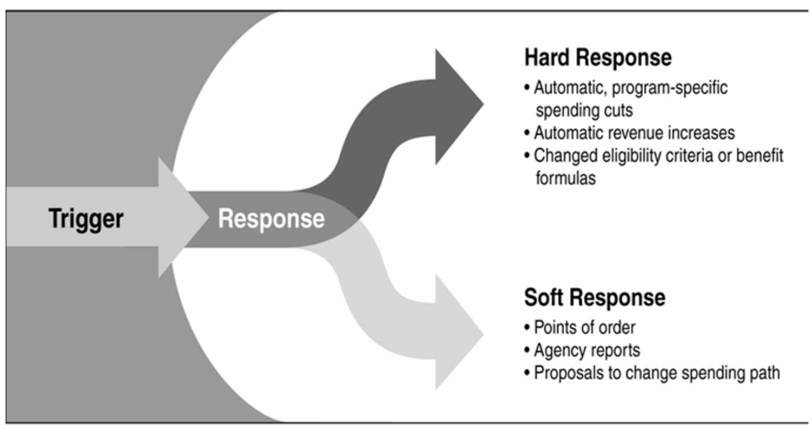
[5] GAO-05-325SP.

[6] GAO, Mandatory Spending: Using Budget Triggers to Constrain Growth, GAO-06-276 (Washington, DC: Jan. 31, 2006).

or requiring the President to submit a proposal to change the path or explain why he thinks it should remain unchanged. The Medicare program already contains a "soft" response trigger: The President is required to submit a proposal for action to Congress if the Medicare Trustees determine in 2 consecutive years that the general revenue share of Medicare spending is projected to exceed 45 percent during a 7-year period.[7] Given the Each year the Social Security and Medicare Trustees test for program financial adequacy over the next 10 years. The results of the test are included in the respective Trustees' reports to Congress, in which they note that failure to meet this test is an indication that action is needed. A few Social Security reform proposals have taken this further by including language requiring Presidential and Congressional action if the Social Security Board of Trustees determines that the balance ratio of either of the Social Security trust funds will be zero for any calendar year during the succeeding 75 years.[8]

Soft responses can help in alerting decision makers of potential problems but they do not ensure that action to decrease spending or increase revenue is taken. With soft responses, the fiscal path continues unless Congress and the President take action. In contrast, a trigger could lead to "hard" responses requiring a predetermined, program-specific action to take place, such as changes in eligibility criteria and benefit formulas, automatic revenue increases, or automatic spending cuts. With hard responses, spending is automatically constrained, revenue is automatically increased, or both, unless Congress takes action to override. For example, this year the President's Budget proposes to change the Medicare trigger from solely "soft" to providing a "hard" (automatic) response if Congress fails to enact the President's proposal.[9] Figure 2 below illustrates the conceptual differences between hard and soft responses of a budget trigger.

FIGURE 2: CONCEPTUAL DIFFERENCES BETWEEN HARD AND SOFT RESPONSES



Source: GAO analysis.

In our recent report on mandatory spending triggers, we discussed the kinds of responses that might be triggered and the importance of program-specific design. Proposed changes in underlying benefits structure and design of a mandatory program can be considered in the context both of the factors that drive the growth of that program and the specific goals and objectives of the program. For example, some mandatories are intended to have a countercyclical effect; any triggered re-

[7] For the purpose of the Medicare trigger, general revenue is defined as the difference between Medicare program outlays and dedicated Medicare financing sources. Dedicated Medicare financing sources are defined as Hospital Insurance (HI) payroll taxes, the HI share of income taxes on Social Security benefits, state transfers for Part D prescription drug benefits, premiums paid under Parts A, B, and D, and any gifts received by the trust funds.

[8] Recently, this provision was included in the Bipartisan Retirement Security Act of 2005, H.R. 440, 109th Cong. § 14 (2005).

[9] The response now would include a sequester if the Congress did not act on the President's proposal. The proposed sequester would result in a four-tenths of a percent reduction in all payments to providers beginning in the year the threshold is exceeded. Each year the shortfall continues to occur the reduction would grow by an additional four-tenths of a percent. We have not yet analyzed how this would work.

sponse in these programs would have to be designed not to interfere with that function. Its design, therefore, would have to be sensitive to whether growth comes because the program is, in fact, working as an automatic stabilizer.

Both near- and long-term perspectives should be considered in the design of triggers. For some programs, it might be appropriate to tie the trigger to historical data—for example, to see whether spending growth was greater than some historical average or path. For programs that expose the government to long-term commitments, it might be more appropriate to tie the trigger to projections of future spending. For "contributory" programs that represent a long-term commitment of future earmarked resources, such as Social Security, one appropriate measure could be the actuarial projections of the 75-year outlook. Some similar approach might be used for programs like pension or health insurance.

Any discussion to create triggered responses and their design must recognize that unlike controls on discretionary spending, there is some tension between the idea of triggers and the nature of entitlement and other mandatory spending programs. These programs—as with tax provisions such as tax expenditures—were designed to provide benefits based on eligibility formulas or actions as opposed to an annual decision regarding spending. This tension makes it more challenging to constrain costs and to design both triggers and triggered responses. At the same time, with only about one-third of the budget under the control of the annual appropriations process, considering ways to increase transparency, oversight, and control of mandatory programs must be part of addressing the nation's long-term fiscal challenges.

Before I turn to the largest driver of our long-term challenge—rising health care costs—let me note that the idea of triggers need not only apply to spending. The revenue side of the budget should also be addressed. If, for example, one option to cover the increased costs of a mandatory spending program was a premium increase or tax increase, it would serve to increase public visibility and could make the American people more aware of how much they are paying for services. More directly analogous to mandatory spending programs is the extensive use of tax incentives, rather than direct spending authority, to address various social objectives. As we reported in September 2005,[10] the sum of revenue loss estimates associated with tax expenditures—such as tax exclusions, credits, and deductions—was nearly $730 billion in 2004.[11] Under the most recent estimates, this has risen to more than $775 billion in 2005.

Let me be clear that in suggesting application of this analysis to tax expenditures I am not addressing the appropriate level of taxation as a share of GDP. Whatever level of revenue is deemed appropriate, tax expenditures that seek to achieve programmatic or policy goals should—like other Federal programs or activities—be reviewed to determine their effectiveness, continued relevance, affordability, and sustainability. Tax expenditures have a significant effect on overall tax rates—in that, for any given level of revenue, overall tax rates must be higher to offset the revenue forgone through tax expenditures—as well as the budget and fiscal flexibility. They also contribute to the growing complexity of the Federal tax system. Many tax expenditures operate like mandatory spending programs and generally are not subject to reauthorization. Such tax expenditures are embedded in the tax system. They are not subject to a performance test and are off the radar screen for the most part. This is a concern from a budgetary standpoint because taxpayer dollars committed to fund these expenditures do not compete in the annual appropriations process and are effectively "fully funded" before any discretionary spending is considered. The analysis we have applied to spending would also be useful in examining tax expenditures.

FEDERAL HEALTH CARE SPENDING DRIVES THE LONG-TERM FISCAL CHALLENGE

Among mandatory spending programs—and indeed tax expenditures—the health area is especially important because the long-term fiscal challenge is largely a health care challenge. Contrary to public perceptions, health care is the biggest driver of the long-term fiscal challenge. While Social Security is important because of its size, health care spending is both large and projected to grow much more rapidly.

Our most recent simulation results illustrate the importance of health care in the long-term fiscal outlook as well as the imperative to take action. Simply put, our nation's fiscal policy is on an imprudent and unsustainable course. These long-term budget simulations show, as do those published last December by the Congressional

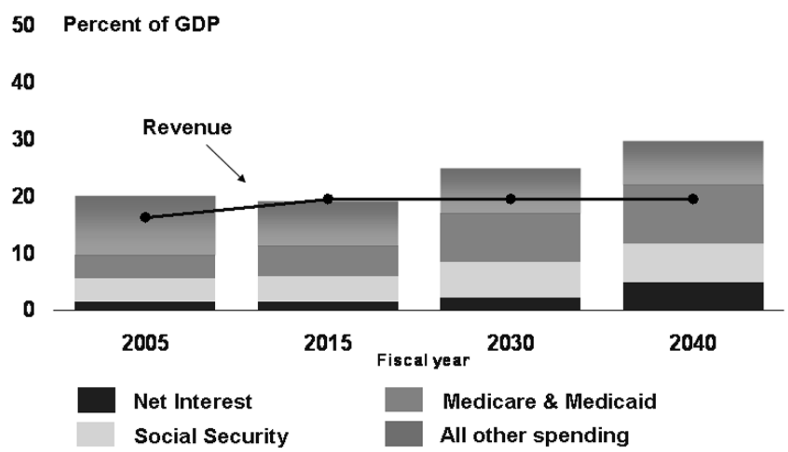
[10] See GAO-05-690.

[11] Summing the individual tax expenditure estimates is useful for gauging the general magnitude of the Federal revenue involved, but it does not take into account possible interactions between individual provisions.

Budget Office (CBO),[12] that over the long term we face a large and growing structural deficit due primarily to known demographic trends and rising health care costs and lower Federal revenues as a percentage of the economy. Continuing on this unsustainable fiscal path will gradually erode, if not suddenly damage, our economy, our standard of living, and ultimately our national security. Our current path also will increasingly constrain our ability to address emerging and unexpected budgetary needs and increase the burdens that will be faced by future generations.

Figures 3 and 4 present our long-term simulations under two different sets of assumptions. In figure 3, we start with CBO's 10-year baseline—constructed according to the statutory requirements for that baseline.[13] Consistent with these requirements, discretionary spending is assumed to grow with inflation for the first 10 years and tax cuts scheduled to expire are assumed to expire. After 2016, discretionary spending is assumed to grow with the economy, and revenue is held constant as a share of GDP at the 2016 level. In figure 4, two assumptions are changed: (1) discretionary spending is assumed to grow with the economy after 2006 rather than merely with inflation, and (2) all expiring tax provisions are extended. For both simulations, Social Security and Medicare spending is based on the 2005 Trustees' intermediate projections, and we assume that benefits continue to be paid in full after the trust funds are exhausted. Medicaid spending is based on CBO's December 2005 long-term projections under mid-range assumptions.

FIGURE 3: COMPOSITION OF SPENDING AS A SHARE OF GDP UNDER BASELINE EXTENDED



Notes: In addition to the expiration of tax cuts, revenue as a share of GDP increases through 2016 due to (1) real bracket creep, (2) more taxpayers becoming subject to the AMT, and (3) increased revenue from tax-deferred retirement accounts. After 2016, revenue as a share of GDP is held constant.

Source: GAO's January 2006 analysis.

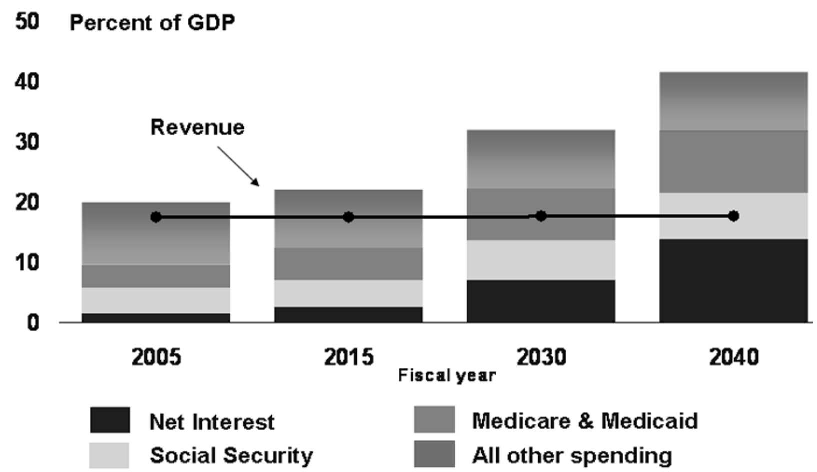
As these simulations illustrate, absent significant policy changes on the spending and/or revenue side of the budget, the growth in mandatory spending on Federal retirement and especially health entitlements will encumber an escalating share of the government's resources. Indeed, when we assume that all the temporary tax reductions are made permanent and discretionary spending keeps pace with the economy, our long-term simulations suggest that by 2040 Federal revenues may be adequate to pay only some Social Security benefits and interest on the Federal debt. Neither slowing the growth in discretionary spending nor allowing the tax provisions to expire—nor both together—would eliminate the imbalance. Although revenues will be part of the debate about our fiscal future, assuming no changes to Social Security, Medicare, Medicaid, and other drivers of the long-term fiscal gap would require at least a doubling of taxes—and that seems highly implausible. Economic growth is essential, but we will not be able to simply grow our way out of the problem. The numbers speak loudly: our projected fiscal gap is simply too great. Closing the current long-term fiscal gap would require sustained economic growth

[12] CBO, The Long-Term Budget Outlook (Washington, DC: December 2005).

[13] CBO, The Budget and Economic Outlook: Fiscal Years 2007 to 2016 (Washington, DC: January 2006).

far beyond that experienced in U.S. economic history since World War II. Tough choices are inevitable, and the sooner we act the better.

FIGURE 4: COMPOSITION OF SPENDING AS A SHARE OF GDP ASSUMING DISCRETIONARY SPENDING GROWS WITH GDP AFTER 2006 AND ALL EXPIRING TAX PROVISIONS ARE EXTENDED



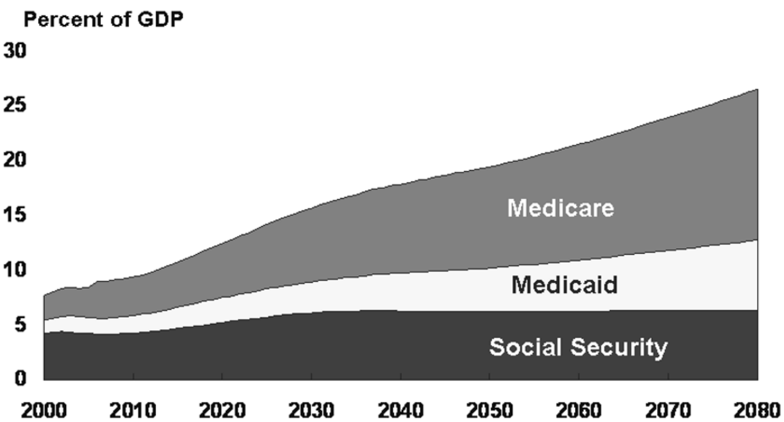
Note: This includes certain tax provisions that expired at the end of 2005, such as the increased AMT exemption amount.
Source: GAO's January 2006 analysis.

Accordingly, substantive reform of the major health programs and Social Security is critical to recapturing our future fiscal flexibility. Ultimately, the nation will have to decide what level of Federal benefits and spending it wants and how it will pay for these benefits. Our current fiscal path will increasingly constrain our ability to address emerging and unexpected budgetary needs and increase the burdens that will be faced by future generations. Continuing on this path will mean escalating and ultimately unsustainable Federal deficits and debt that will serve to threaten our future national security as well as the standard of living for the American people.

The aging population and rising health care spending will have significant implications not only for the budget, but also the economy as a whole. Figure 5 shows the total future draw on the economy represented by Social Security, Medicare, and Medicaid. Under the 2005 Trustees' intermediate estimates and CBO's 2005 long-term Medicaid estimates under mid-range assumptions, spending for these entitlement programs combined will grow to 15.7 percent of gross domestic product (GDP) in 2030 from today's 8.4 percent. It is clear that, taken together, Social Security, Medicare, and Medicaid represent an unsustainable burden on future generations.

Furthermore, most of the long-term growth is in health care. While Social Security in its current form will grow from 4.3 percent of GDP today to 6.4 percent in 2080, Medicare's burden on the economy will quintuple—from 2.7 percent to 13.8 percent of the economy—and these projections assume a growth rate for Medicare spending that is below historical experience! As figure 5 shows, unlike Social Security which grows larger as a share of the economy and then levels off, within this projection period we do not see Medicare growth abating. Whether or not the President's Budget proposals on Medicare are adopted, they should serve to raise public awareness of the importance of health care costs to both today's budget and tomorrow's. This could serve to jump start a discussion about appropriate ways to control the major driver of our long-term fiscal outlook—health care spending.

FIGURE 5: SOCIAL SECURITY, MEDICARE, AND MEDICAID SPENDING AS A PERCENT OF GDP



Source: GAO analysis based on data from the Office of the Chief Actuary, Social Security Administration, Office of the Actuary, Centers for Medicare and Medicaid Services, and the Congressional Budget Office.

Note: Social Security and Medicare projections based on the intermediate assumptions of the 2005 Trustees' Reports. Medicaid projections based on CBO's January 2006 short-term Medicaid estimates and CBO's December 2005 long-term Medicaid projections under mid-range assumptions.

As noted, unlike Social Security, Medicare spending growth rates reflect not only a burgeoning beneficiary population, but also the escalation of health care costs at rates well exceeding general rates of inflation. The growth of medical technology has contributed to increases in the number and quality of health care services. Moreover, the actual costs of health care consumption are not transparent. Consumers are largely insulated by third-party payers from the cost of health care decisions.

The health care spending problem is particularly vexing for the Federal budget, affecting not only Medicare and Medicaid but also other important Federal health programs, such as for our military personnel and veterans. For example, Department of Defense health care spending rose from about $12 billion in 1990 to about $30.4 billion in 2004—in part, to meet additional demand resulting from program eligibility expansions for military retirees, reservists, and the dependents of those two groups and for the increased needs of active duty personnel involved in conflicts in Iraq, Bosnia, and Afghanistan. Expenditures by the Department of Veterans Affairs have also grown—from about $12 billion in 1990 to about $26.8 billion in 2004—as an increasing number of veterans look to Federal programs to supply their health care needs.

The challenge to rein in health care spending is not limited to public payers, however, as the phenomenon of rising health care costs associated with new technology exists system-wide. This means that addressing the unsustainability of health care costs is also a major competitiveness and societal challenge that calls for us as a nation to fundamentally rethink how we define, deliver, and finance health care in both the public and the private sectors. A major difficulty is that our current system does little to encourage informed discussions and decisions about the costs and value of various health care services. These decisions are very important when it comes to cutting-edge drugs and medical technologies, which can be incredibly expensive but only marginally better than other alternatives. As a nation, we are going to need to weigh unlimited individual wants against broader societal needs and decide how responsibility for financing health care should be divided among employers, individuals, and government. Ultimately, we may need to define a set of basic and essential health care services to which every American is ensured access. Individuals wanting additional services, and insurance coverage to pay for them, might be required to allocate their own resources. Clearly, such a dramatic change would require a long transition period—all the more reason to act sooner rather than later.

In recent years, policy analysts have discussed a number of incremental reforms that take aim at moderating health care spending, in part by unmasking health care's true costs. (See fig. 6 for a list of selected reforms.) Among these reforms is to devise additional cost-sharing provisions to make health care costs more transparent to patients. Currently, many insured individuals pay relatively little out of pocket for care at the point of delivery because of comprehensive health care coverage—precluding the opportunity to sensitize these patients to the cost of their care.

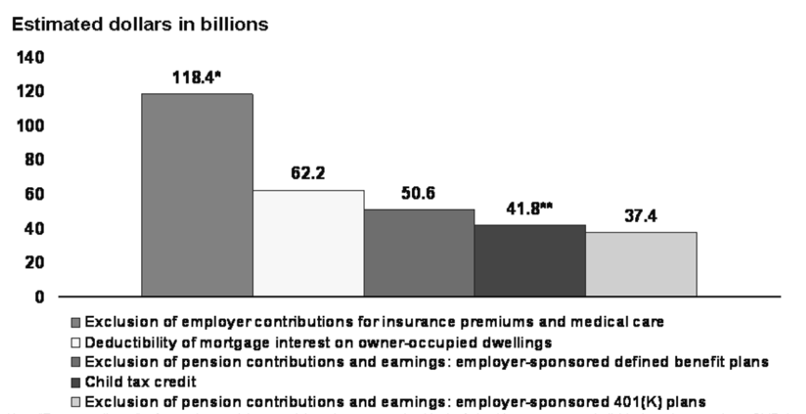
FIGURE 6: SELECTED REFORMS AIMED AT MODERATING HEALTH CARE SPENDING

- Develop a set of national practice standards to help avoid unnecessary care, improve outcomes, and reduce litigation.
- Encourage case management approaches for people with expensive acute and chronic conditions to improve the quality and efficiency of care delivered and avoid inappropriate care.
- Foster the use of information technology to increase consistency, transparency, and accountability in health care.
- Emphasize prevention and wellness care, including nutrition.
- Leverage the government's purchasing power to control costs for prescription drugs and other health care services.
- Revise certain Federal tax preferences for health care to encourage the more efficient use of appropriate care.
- Create an insurance market that adequately pools risk and offers alternative levels of coverage.
- Develop a core set of basic and essential services with supplemental coverage being available as an option but at a cost. Use the Federal Employees Health Benefits Program (FEHBP) model as a possible means to experiment and see the way forward.
- Limit spending growth for government-sponsored health care programs (e.g., percentage of the budget and/or the economy).

Source: GAO

Other steps include reforming the policies that give tax preferences to insured individuals and their employers. These policies permit the value of employees' health insurance premiums to be excluded from the calculation of their taxable earnings and exclude the value of the premium from the employers' calculation of payroll taxes for both themselves and employees. Tax preferences also exist for health savings accounts and other consumer-directed plans. These tax exclusions represent a significant source of forgone Federal revenue and work at cross-purposes to the goal of moderating health care spending. As figure 7 shows, in 2005 the tax expenditure responsible for the greatest revenue loss was that for the exclusion of employer contributions for employees' insurance premiums and medical care.

FIGURE 7: HEALTH CARE WAS THE NATION'S TOP TAX EXPENDITURE IN FISCAL YEAR 2005



Note: "Tax expenditures" refers to the special tax provisions that are contained in the federal income taxes on individuals and corporations. OMB does not include forgone revenue from other federal taxes such as Social Security and Medicare payroll taxes.
*If the payroll tax exclusion were also counted here, the total tax expenditure for employer contributions for health insurance premiums would be about 50 percent higher or $177.6 billion.
**This is the revenue loss and does not include associated outlays of $14.6 billion.

Source: Office of Management and Budget (OMB), *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2007.*

Another area conducive to incremental change involves provider payment reforms. These reforms are intended to induce physicians, hospitals, and other health care providers to improve on quality and efficiency. For example, studies of Medicare patients in different geographic areas have found that despite receiving a greater volume of care, patients in higher use areas did not have better health outcomes or experience greater satisfaction with care than those living in lower use areas. Public and private payers are experimenting with payment reforms designed to foster the delivery of care that is proven to be both clinically and cost effective. Ideally, identifying and rewarding efficient providers and encouraging inefficient providers to emulate best practices will result in better value for the dollars spent on care. The development of uniform standards of practice could lead to ensuring that people with chronic illnesses, a small but expensive population, received more and cost-effective and patient-centered care while reducing unwarranted medical malpractice litigation.

The problem of escalating health care costs is complex because addressing Federal programs such as Medicare and the federal-state Medicaid program will need to involve change in the health care system of which they are a part—not just within Federal programs. This will be a major societal challenge that will affect all age groups. Because our health care system is complex, with multiple interrelated pieces, solutions to health care cost growth are likely to be incremental and require a number of extensive efforts over many years. In my view, taking steps to address the health care cost dilemma system-wide puts us on the right path for correcting the long-term fiscal problems posed by the nation's health care entitlements.

I have focused today on health care because it is a driver of our fiscal outlook. Indeed, health care is already putting a squeeze on the Federal budget.

Health care is the dominant but not the only driver of our long-term fiscal challenge. Today it is hard to think of our fiscal imbalances as a big problem: the economy is healthy and interest rates seem low. We, however, have an obligation to look beyond today. Budgets, deficits, and long-term fiscal and economic outlooks are not just about numbers: they are also about values. It is time for all of us to recognize our stewardship obligation for the future. We should act sooner rather than later. We all must make choices that may be difficult and unpleasant today to avoid passing an even greater burden on to future generations. Let us not be the generation who sent the bill for its consumption to its children and grandchildren.

Thank you Mr. Chairman, Mr. Spratt, and members of the Committee for having me today. We at GAO, of course, stand ready to assist you and your colleagues as you tackle these important challenges.

Mr. WICKER. Dr. Holtz-Eakin is recognized.

STATEMENT OF DOUGLAS J. HOLTZ-EAKIN

Mr. HOLTZ-EAKIN. Thank you, Mr. Chairman, Congressman Spratt and other members of the committee. It is indeed a pleasure to be back in front of this committee.

If I could, I would like to make two personal observations before I begin and the first is to say thank you to the chairman and Mr. Spratt and the members for the very gracious remarks that were entered into the Congressional Record when I left the Congressional Budget Office, far too gracious. And the second is that I want to say for the record, writing your own testimony is a lot of work. It is a pleasure to be back.

I have a written statement, which I have submitted.

Let me just say a couple of things, and then we can talk about this with your questions. The first is I am pleased that there is now a general recognition, at least in this committee, of the scale of the long-term problem facing the Federal Government, indeed the U.S. Economy. I believe that coming to terms with the scale of spending under current law for the mandatory programs is our most pressing policy issue. It is one that is at the core of maintaining the vitality of productive growth in the United States. It is at the core of maintaining our international competitiveness, and it is at the core of the issues in national saving and investment which will ultimately dictate our financial position versus the rest of the world. So I can't say that, my experience outside of this room, everyone recognizes the scale of this problem, but it is nice to see it acknowledged right up front and acknowledge that we can't grow out of it, that this is a policy issue.

Second, I would say again that there are strategies for reform that are political in nature, but from a policy point of view, the right time to do it is now, and the sooner the better, because this problem is fundamentally demographic in nature, and the retirement of the baby boom is indeed upon us in any real sense. And so, to stay at this issue, beginning right now is essential.

Over the long term, there will be a set of key policy issues that have to be addressed, and then hopefully budgetary mechanisms that can support those policy issues. I think the threshold question for this government and which the committee will have to grapple with is how large of a Federal Government will we like to have in the United States?

The current spending places the United States on track to have a much larger Federal Government than it has in the past. That Federal Government would, of necessity, be financed by higher taxes than has historically been the case in the United States, and that combination will carry an economic cost. The economy will not grow as fast. It will have some detrimental impacts. And that trade-off is one that is crucial and one that should be made clear in the deliberations.

In my written testimony, I talked about three things that—three strategies which are not mutually exclusive that one might take in addressing the mandatory programs, and the first would be to think of the programs in their current incarnation and reform them on a program-by-program, stand-alone basis. So one could revisit Social Security, recognize that the core policy problem is that benefits promised are 2 percentage points greater than revenues dedicated for as far as the eye can see, and come up with a set of approaches that would narrow that gap, whether they be raising retirement ages, changing the indexation of benefits at initial award or in retirement, adopting different strategies for young versus old cohorts to allow greater prefunding. Whatever that mix might be, you could look at Social Security separately from the other programs. And if so, I would argue Social Security is the place to start because it is the best understood program, and it is the easiest analytically to both diagnose and fix. There is a large menu of solutions that involve both prefunding of individual accounts and without, so if that is the strategy, start with Social Security and make a budgetary allowance for that.

Cutting—moving to health care would be much harder as Mr. Walker said. The changes necessary to fix the health care system which ultimately affect the growth rate of Medicare and Medicaid should be far more incremental in nature. It is a cost growth disease that is far harder to diagnose, and less obvious remedies are available. We can talk about some of the possibilities, but it is very different from Social Security in that regard.

So one set of strategies is simply to do program by program in the existing fashion. An alternative would be to step back and recognize that the core question is what will be the commitment of taxpayer dollars to old age programs. And those old age programs are for retirement income, they are for health care, they are for long-term care and nursing home services. They are for a set of lifestyle in retirement support that come from many programs in the U.S. budget.

One could revisit the policy and think about the degree to which there will be a commitment of resources to those programs and those needs, redesign them in a cohesive fashion, and then, having made that commitment, finance it in a sensible fashion over the long term.

There, I think, the great lesson is in long-term care services. If one looks at the care of our most disabled in the United States, the majority of those who are even severely disabled received all of their long-term care from donated care, from family members who simply help them out. In the future we will have more such demand, and we will have fewer such family members as women are increasingly in the labor force. We will have to develop strategies that allow these services to be provided through market mechanisms. We will then have to decide whether they will be financed by the kids or prefunded and financed by the elderly themselves, and decide whether that prefunding will take the form of real reserves in a private insurance program or some other mechanism. And so, if one could come to terms with the appropriate design of long-term care in the United States, that would be a great indicator for how to deal with health care and then retirement income.

And then finally, the third possibility is to do something that will probably be necessary in either event, which is to each year come back to the reconciliation process, use the parliamentary procedures that allow addressing the mandatory programs. In doing that, I think the good news from this past year is that reconciliation on the spending took place. That is something that was not regular business in the U.S. Congress. This was the first time in 8 years. And I think it is good news that it was undertaken.

We can debate at length whether the size of the spending reductions was at all significant given the scale of the problem. It really doesn't look that big.

Going forward, it might be possible to use triggers of the type that Mr. Walker talked about to kick off the reconciliation process. One could imagine mechanisms that were close in spirit to the sustainable growth rate mechanism used for payments to Medicare physicians. In that Congress essentially dictated a level of growth that was acceptable. And you could do that for each of the mandatory programs, which have very different growth rates. Given that acceptable growth rate, you could then trigger either explicit policy actions on the part of the authorized committees to bring it down to that growth rate, so if you are above that growth rate, you must take action, and you are given reconciliation instructions to do so. That would be a soft trigger, in the words that the GAO used. Or you could have an automatic cut as the SGR does and have that threat of the automatic cut be the triggering mechanism that may cause reconciliation.

I would argue that the track record of the SGR is not one of uniform success, and that a soft trigger controlled by the Budget Committee in the resolution might be a better way to go.

But in any event, this is the future of this committee dealing with reconciliation on a regular basis. These mandatory programs are the pressing national concern. And I look forward to both answering your questions today and working with the committee as the need arises. Thank you.

Mr. WICKER. Thank you very, very much.

[The prepared statement of Douglas Holtz-Eakin follows:]

PREPARED STATEMENT OF DOUGLAS J. HOLTZ-EAKIN, DIRECTOR, MAURICE R. GREENBERG CENTER FOR GEOECONOMIC STUDIES, PAUL A. VOLCKER CHAIR IN INTERNATIONAL ECONOMICS, COUNCIL ON FOREIGN RELATIONS

Chairman Nussle, Ranking Member Spratt and members of the Committee, I am pleased to have the opportunity to discuss the topic of mandatory spending in the Federal budget. In my remarks, I wish to make the following four points:

1. Mandatory spending is currently two-thirds of Federal spending, and will grow rapidly as the United States undergoes it demographic transition—especially outlays for Social Security, Medicare and Medicaid. These programs merit review and reform because:

- The demographic shift is a permanent change in the landscape in which these programs operate;
- Economic growth alone will not alleviate the burden of rising spending for these programs; and
- The demographic shift has arrived, so efforts to control their growth should begin soon.

2. The amount of spending is the best measure of the size of government. Having made the commitment to spend funds, this commitment must ultimately be paid for in higher taxes in either the present or the future.

3. The size and growth of the U.S. economy is the central source of the international standing of the United States, its ability to project power and influence international affairs, and to provide for domestic priorities. A central question in the decades to come will be the size of the Federal Government and the degree to which its budgetary activities diminish the potential for private sector economic growth.

4. There are several alternative strategies to controlling the growth of future outlays.

- Fundamental reform on a program-by-program basis, such as reforms of Social Security or Medicare on a stand-alone basis;
- Cross-cutting reforms of programs that have a common basis in demographic shifts; or
- Incremental reform on a continual basis, such as would be accomplished by reconciliation instructions on an annual schedule.

Let me brief discuss each point in turn.

THE FUTURE GROWTH OF MANDATORY SPENDING

It is useful to begin with the spending outlook.[1] Left unaltered, over the next fifty years spending for Social Security will rise dramatically, increasing about 50 percent from its current level of just over four cents out of each national dollar. In the process, Social Security will be transformed from a cash cow that provides excess funds to the remainder of the Federal budget to a cash drain that will require annual infusions totaling over $300 billion (in today's dollars). The rise in Social Security spending is predictable—most of these recipients are already in the labor force—and results from the permanent shift to an older population that will accompany the retirement of the baby boom generation. After this shift is completed, scheduled Social Security benefits will be roughly 7 percent of GDP, and rise slowly as longevity increases in the future.

In contrast, spending on Federal health programs, Medicare and Medicaid, will be driven not only by sure, steady annual aging, but also by health care spending that will outpace income growth. How fast will spending grow? Nobody can know for sure, but if the history of the past four decades repeats itself between now and 2050, Medicare and Medicaid spending will rise from a level comparable to Social Security (four cents out of each national dollar) to over 20 percent of national income. To put it another way, health programs alone will be as large as the entire current Federal Government. (Many believe this "just can't happen," but that raises the question of how spending growth will moderate.)

In any scenario, the demand for mandatory spending in Social Security and health programs swamps all projections of the future of the Federal Government.

[1] This testimony draws heavily on the projections by the Congressional Budget Office contained in The Long-Term Budget Outlook, December 2005. All interpretation, however, is strictly my own.

Fine-tuning the outlook for defense spending, international aid, education, worker-adjustment assistance and the myriad of other policy initiatives does not change the basics.

MEASURING THE SIZE OF GOVERNMENT

The projected growth of spending is important. A good (if not perfect) measure of the "size of government"—the economic burden of a government's programs—is spending. Spending on government programs diverts resources from the private sector—from consumption or investment—to the use of government. If the transfer replaces private consumption with government consumption, then the costs are felt immediately as lower private consumption. If the impact is to "crowd out" private investment, then the cost is slower growth in productive capacity. This loss persists into the future, ultimately lowering consumption at some future time.

The means by which the Federal Government finances that spending—either via taxes or borrowing—is the mechanism by which the resources are taken from the private sector. But the key is not the particular mechanism that is used, but rather the fact that the decision to spend itself imposes the burden. Because the use of dollars for one purpose precludes their use for another, government spending always has a burden. When Members are deciding whether to spend $1 billion for a Federal program, they are choosing such a burden—even without a discussion about taxes. Unless other expenditures are reduced, current or future taxpayers will be required to pay more and give up their income to cover the costs.

THE IMPORTANCE OF SUPPORTING ECONOMIC GROWTH

The United States must meet enormous challenges to its security, strategic influence and international competitiveness. Over the past 100 years, annual growth of Gross Domestic Product has averaged 3.4 percent, a pace that has permitted the U.S. to become the dominant global economic power. The American economy serves as the well of resources to meet defense needs, international assistance, and other policy goals. Similarly, the ultimate purpose of U.S. economic competitiveness is to provide sustained increases in our citizens' standard of living.

How has the United States achieved this record? U.S. economic success is largely due to the strength of the private sector. The mirror image of reliance on private markets is commitment to a government sector that is relatively small (granted, "small" is in the eye of the beholder) and contained. Growth in spending of the magnitude promised by current laws guarantees a much larger government.

Second, the small U.S. government has been financed by taxes that are relatively low by international standards and interfere relatively little with economic performance (the same caveat applies to "low" and "little "). Spending increases of the type currently promised guarantee higher taxes and impaired economic growth.

Finally, a hallmark of the U.S. economy has been its ability to flexibly respond to new demands and disruptive shocks. In an environment where old-age programs consume nearly every budget dollar, to address other policy goals politicians may resort to mandates, regulations, and the type of economic handcuffs that guarantee lost flexibility. Why should the government book the costs of homeland security, or worker training, or new initiatives when it can demand that the private sector do it "free"?

Doing nothing is not an option. The United States is highly unlikely to "grow its way out" of the burden of the projected spending growth. To see this, consider the mix of budgetary and economic events necessary for "business as usual" to be sustainable (to maintain a steady ratio of Federal debt to GDP) over the long term. First, assume that long-term productivity growth remains at the trend experienced in the past decade—a period of rapid productivity increase. Next, assume that the Federal Government collects roughly 18 cents on the national dollar in taxes—close to the postwar average. Third, permit Social Security outlays to grow as currently scheduled, but couple this with extreme discipline on discretionary spending and small mandatory programs—essentially frozen in real terms for the next five decades. Certainly, this sounds like a recipe for government of the same size as in the past. Will it work?

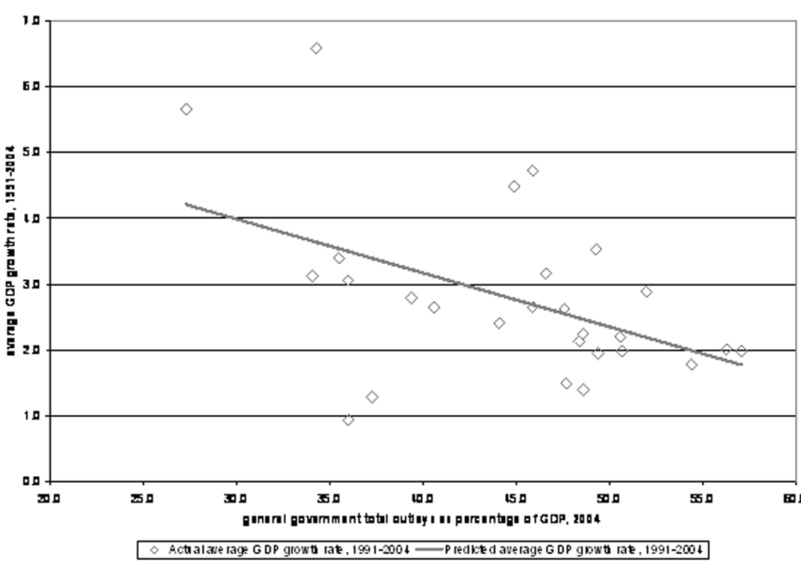
The key is the growth of health care outlays. If, but only if, health care spending per beneficiary grows no faster than income per capita, then outlays and taxes will balance sufficiently that sustained growth will keep the debt-to-GDP ratio stable. The bad news is that over the past four decades, spending per beneficiary has annually grown 2.5 percent faster than income per capita. Even a radical drop to spending that grows only 1 percent faster (or, equally miraculous, GDP growth that was 1.5 percent faster every year) leads to explosive debt growth.

In short, the key is not to count on economic growth to eliminate pressures from spending. Instead, the challenge is to control spending sufficiently to permit adequate long-term growth. The central economic impact of rapid spending growth is to further tilt the nation away from saving for the future. Retirement income and health programs are intended to ensure that beneficiaries can consume goods, services, and health care. Taxes (or their moral equivalent, Federal borrowing) that finance Federal spending do not undo the damage by offsetting the increased consumption. The net loss of savings, in turn, slows the accumulation of funds needed to finance the foundations of sustained growth: the innovation and deployment of new technologies, the acquisition of skills education and skills, and the purchase of new equipment, software, and structures. While the U.S. builds from a position of economic strength—its sustained productivity growth is the envy of other advanced economies—the imminent growth of spending is potentially a self-inflicted threat to this foundation.

An illustration of the potential impacts may be drawn from the experiences of the OECD countries. The figure below displays the relationship between the size of government and the average rate of growth in real GDP.[2] Not only is the relationship negative, the long-run impacts are quite significant. For example, raising the size of government by 10 percentage points—less than would be likely in the absence of changes in mandatory programs, would result in growth that is slower by 0.8 percentage points annually. Even such seemingly small changes accumulate over long periods of time. If growth was slower by 0.8 percentage points annually, standards of living in the United States would rise by 30 percent less than otherwise.

It is desirable to change course immediately. The sooner the 21st century old-age programs are finalized, the sooner workers can make sensible retirement plans, and the sooner the economy as a whole will begin to benefit. Perhaps most importantly, immediate reform recognizes the demographic foundations of the problem: spending will rise with the retirement of the baby boomers; reform must beat the boomers to the retirement finish line.

RELATIONSHIP BETWEEN SIZE OF GOVERNMENT AND GDP GROWTH



STRATEGIES FOR CONTROLLING MANDATORY SPENDING

Broadly speaking, there are three broad strategies—not mutually exclusive—for controlling the growth of mandatory spending. The first is to undertake fundament reform on a program-by-program basis. That is, one could undertake separate reforms of Social Security, Medicare, Medicaid, and other mandatory spending programs. If so, there is a strong argument to begin with Social Security.

[2] I thank Michael Boskin at the Hoover Institution for these data and analyses.

The underpinnings of growth in Social Security outlays are well-understood. Moreover, there exist a wide variety of modifications to the basic program—increases in the normal and early retirement age, changes in the indexation of initial benefit awards, changes to the cost-of-living indexation during retirement, altering benefits to reflect longevity, and others—that would slow the growth of outlays. If undertaken quickly, such changes would resolve uncertainty about the future of the program, thereby benefiting workers in planning their retirement. Moreover, such changes would also likely raise household saving, especially if coupled with explicit pre-funding of future benefits, and provide a direct benefit to the accumulation of capital in the United States.

In contrast, the growth in Medicare and Medicaid is largely driven by underlying trends in health spending, and these are less well understood. The key requires not only slowing the growth of outlays, but making sure that we get quality for each dollar of spending. Given the scale of the challenge, it is likely that there is no single reform needed, but rather a long series of adjustments to ensure that the United States does not overspend on health care.

A second strategy would recognize that the problems of retirement income (Social Security), old-age health care (Medicare) and long-term care services (Medicaid) share a common demographic basis. Moreover, there is little to distinguish between home-based care services and either some outpatient health therapies, or the spending of retirement income to maintain a desired lifestyle. In short, there may be merit to rethinking these programs from the perspective of ensuring an adequate accumulation and foundation for old-age requirements in all three areas.

Finally, it may be the case that mandatory spending in these areas requires continual adjustments. One way to undertake such controls is through proactive, regular implementation of the reconciliation process. However, it may be desirable to augment such procedures by augmenting the budget process with indicators of the need for such efforts. For example, in the current Medicare program, physician payments are governed by the Sustainable Growth Rate (SGR) mechanism, which limits cumulative payments. In the absence of changes by the Congress, the SGR automatically reduces payments and lowers the growth of spending.

A broader set of SGR-like mechanisms could be used to set a "baseline" level of mandatory spending growth—say at the rate of GDP growth. To permit faster-than-GDP growth, the budget resolution could specify allocations for authorizing committees that open the possibility of greater program expansion. In their absence, however, spending would have to be controlled to stay at the sustainable rate.

An alternative approach is the use of triggering mechanisms to specify cuts—perhaps unpalatable cuts—automatically and thereby induce action to change mandatory programs. An example is the Administration's recent proposal for automatic reductions in Medicare if the program requires greater than 45 percent in general revenue.

CONCLUSION

To summarize, controlling the future growth of mandatory spending—especially that in old-age programs—is central to controlling the size of the Federal Government, fostering future economic growth, and maintaining a sustainable fiscal policy. Thank you for the opportunity to appear today, and I look forward to your questions.

Mr. WICKER. Dr. Isabel Sawhill is senior fellow at the Brookings Institution, and we welcome you, Dr. Sawhill.

STATEMENT OF ISABEL V. SAWHILL

Ms. SAWHILL. Thank you, Mr. Chairman. I want to thank you and Mr. Spratt and other members of the committee for giving me the opportunity to be here today.

I will quickly summarize my main points. Obviously we are more concerned about deficits. We do need to focus on entitlements. They are more than half the budget. They are growing very rapidly, especially the health care programs. We already talked about that.

Mr. WICKER. Dr. Sawhill, would you check your speaker?

Ms. SAWHILL. Sorry. Is that better?

I began simply by saying I appreciate the opportunity to be here, and that like everyone else who has already spoken, I think we need to be concerned about the growth of entitlements in the budget.

And if we look out into the future, it seems to us, to those of us who worked on this at Brookings anyway, that there are only three choices. One is to restructure entitlements in a major way, the second is to eliminate most of the rest of government, and the third is to raise taxes to unprecedented levels.

Now, obviously, realistically, we are probably going to do some of all three, but I think it is very important to not just muddle through and do some mix of those things that nobody ever intended or anticipated, and to instead have a longer-range plan.

As long as entitlements are left off the table, and I think we all know that they are harder to address than some other parts of the budget, the pressure does fall more heavily on domestic discretionary programs, particularly at a time like now when we are at war. And that, I think, is likely to lead to underinvestment in the future and to an undermining of economic growth and competitiveness as a result. And it is also likely to lead to disproportionate cuts in programs for low- and moderate-income families.

In my testimony, I support the appointment of a bipartisan commission on entitlement reform that the President called for in the State of the Union, but with the caveat that the commission needs to be viewed as highly credible and politically independent.

I also argue that taxes will have to be on the table. It is not possible to solve our fiscal problems with suspending cuts alone, although those are surely needed.

I also suggest a set of principles that might guide the commission's work, such as moving toward greater income relating of benefits, such as moving toward defined contributions and not justifying benefits in health and retirement programs. I am not, by the way, arguing for eliminating the current system of defined benefits as a core tier in, for example, the Social Security System, but rather for adding to that core tier a set of mandated individual accounts that would enhance retirement security.

That said, I believe that it is going to take a very long time for the political system to enact any such set of reforms and longer still for them to take effect and begin to have an influence on our fiscal situation.

For those reasons, like others here, today, I do talk about triggers. And I propose that the Congress consider a temporary suspension or partial suspension of indexing for inflation of both benefits and taxes. This suspension would remain in effect until a preset deficit reduction goal was achieved. The goal could be to enact policy measures that made steady progress toward halving the deficit within 5 years, as an example.

While such a proposal would be difficult to enact, it would have a number of attractive features, in my view. First, it could be justified on the grounds that it would call for broad-based sacrifice from the public to pay for the war and for the rebuilding after Katrina, but it would not affect any one family very much, especially if low-income programs were exempted.

Second, it would reduce the deficit by roughly $150 billion over 3 years, which would be a good chunk.

Third, like some earlier budget rules, it would provide a strong incentive for Congress to reform entitlements and taxes in ways that would reduce the deficit since the temporary suspension would remain in effect until certain goals were achieved.

So I will leave it at that. I would add that I am also in favor of the bringing back the kind of PAYGO and discretionary caps that I think were very effective in the 1990s. I served in the Office of Management and Budget during the Clinton administration, and I had responsibility for the one-third of the budget that is devoted to social programs, and those, of course, were the President's highest priorities. And yet because we were operating under PAYGO, and because we were operating under discretionary caps, we had to make very, very tough decisions all the time. So those kinds of rules do help. But those rules, if we were to reinstate them, would prevent digging the hole any deeper. They would enforce the kind of action—difficult actions—that I think are needed in the future. So if I had to have my druthers, I would suggest both to you.

Thank you very much.

[The prepared statement of Isabel Sawhill follows:]

PREPARED STATEMENT OF ISABEL V. SAWHILL, SENIOR FELLOW AND DIRECTOR, ECONOMIC STUDIES, THE BROOKINGS INSTITUTION

Mr. Chairman, Mr. Spratt, and Members of the Committee, I am Isabel Sawhill, Senior Fellow and Director of Economic Studies at the Brookings Institution. I am pleased to have this opportunity to testify but want to emphasize that my testimony represents my personal views and not those of the Brookings Institution or any of its other scholars, trustees, advisers, or funders. Let me begin by summarizing my testimony.

OVERVIEW

In efforts to restore fiscal balance, it's important to focus on entitlements for a number of reasons:

- Entitlements are where the big dollars are.
- They are growing rapidly.
- Given the unsustainable deficits that this growth implies, there are only three possible options: restructure entitlements, eliminate most of the rest of government, or raise taxes to unprecedented levels.
- Sooner or later, entitlements will have to be addressed-and sooner is much better than later.
- As long as entitlements are left off the table, all of the pressure will fall on discretionary programs.
- That pressure is likely to lead to underinvestment in the next generation and to cuts in programs for low-income families.

What might be done?

In the long-run, new but politically contentious ideas should be considered and debated, such as:

- Moving toward income-relating benefits but in ways that protect the vulnerable
- Increasing the normal retirement age
- Moving from defined benefits to defined contributions in retirement and health programs
- Making the contributions mandatory
- Using public health programs to introduce greater efficiency and effectiveness into the entire health care system
- Raising existing taxes by broadening the tax base for both payroll and income taxes and adding a value-added tax to the mix
- In the short-run, Congress should consider a temporary suspension (or partial suspension) of indexing of both benefits and taxes that would remain in effect until a preset deficit reduction goal is achieved. I estimate that this would save $150 billion over 3 years (2007-2009).

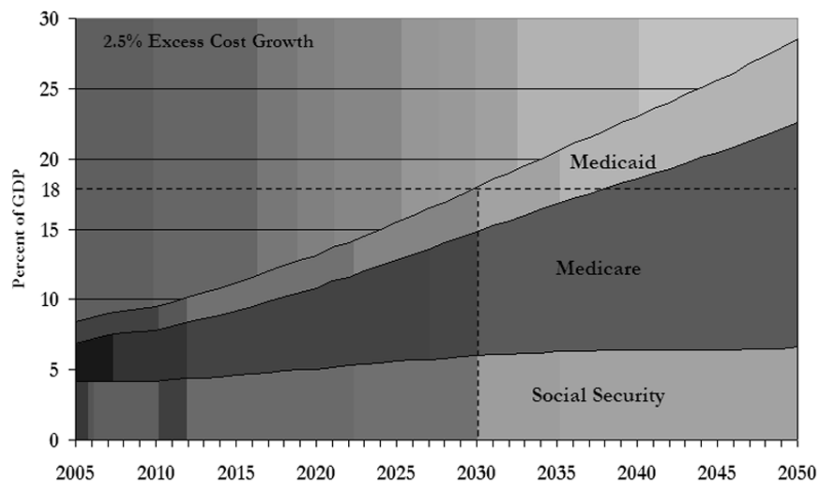
WHY FOCUS ON ENTITLEMENTS?

At present, 84 percent of the Federal budget is for entitlements, defense, homeland security, or interest on the debt. Any effort to achieve a reduction in spending by focusing on the remaining 16 percent is unlikely to be very effective. For example, a 1 percent cut in nominal non-security discretionary spending for 1 year reduces total spending by only 0.17 percent. Over 5 years, it reduces total spending by 0.89 percent.

Entitlements, on the other hand, represented 53 percent of total Federal spending in 2005 with Social Security, Medicare, and Medicaid representing 41 percent of the total.[1] These three programs are growing rapidly, and along with interest on the debt, will absorb all projected Federal revenues by the early 2030's (Figure 1).

Figure 1:

Congressional Budget Office Projection of Social Security, Medicare, and Medicaid



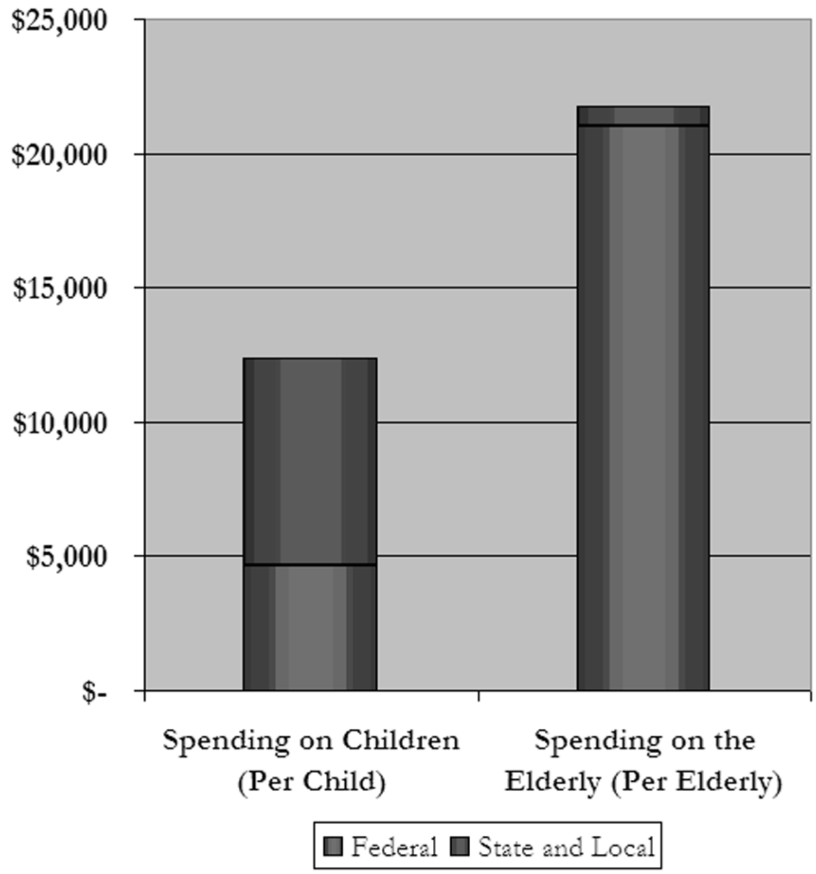
Source: Congressional Budget Office, The Long-Term Budget Outlook, December 2005, Scenario 1

The reasons for this rapid growth include the aging of the population (greater longevity, in particular-not just the retirement of the large baby boom generation) and rapidly increasing spending on health care. Health care spending per capita has been growing at a rate that is 2.5 percentage points greater than GDP per capita for about 40 years and given continuing improvements in medical technologies (better diagnosis, new treatments, and new drugs), no one expects this rate of increase to slow any time soon. For this reason, spending on Medicare is projected to grow 5 times faster than spending on Social Security between now and 2030 and is thus the major challenge to controlling the growth of entitlements.[2] A variety of health care reforms-from greater use of electronic records to curtailing malpractice awards-could reduce the level of spending somewhat, but are not likely to constrain spending growth very much, except perhaps temporarily.

Last year I and my colleagues at Brookings published a volume entitled Restoring Fiscal Sanity, 2005: Meeting the Long-Run Challenge. The book concluded that projected deficits over the next 25 years are unsustainable and that, as a result, there are only three possible options: restructure entitlements, eliminate most of the rest of government, or raise taxes by one third or more.[3] We and many others have emphasized that addressing the growth of entitlements sooner rather than later will be far less painful than if we wait until the day of reckoning has arrived. Not only will delay require sharp increases in taxes or major benefit cuts, but the intervening accumulation of debt will necessitate that a rising proportion of available revenues be used to pay interest on that debt. Under realistic assumptions, interest on the debt is currently slated to grow to around $466 billion in 2016. Thus, over one out of every four income tax dollars will buy nothing except the right of the Federal Government to continue to borrow.[4]

Restoring Fiscal Sanity 2005 outlines and estimates the budgetary savings or revenue enhancements associated with a number of specific options such as increasing the retirement age for both Social Security and Medicare, changing benefit formulas in Social Security, imposing higher Medicare premiums on the affluent, introducing more market discipline or more rationing into the health care system, raising payroll or income taxes, and introducing a VAT.

Figure 2:
2003 Spending by Level of Government
(2005 Dollars)



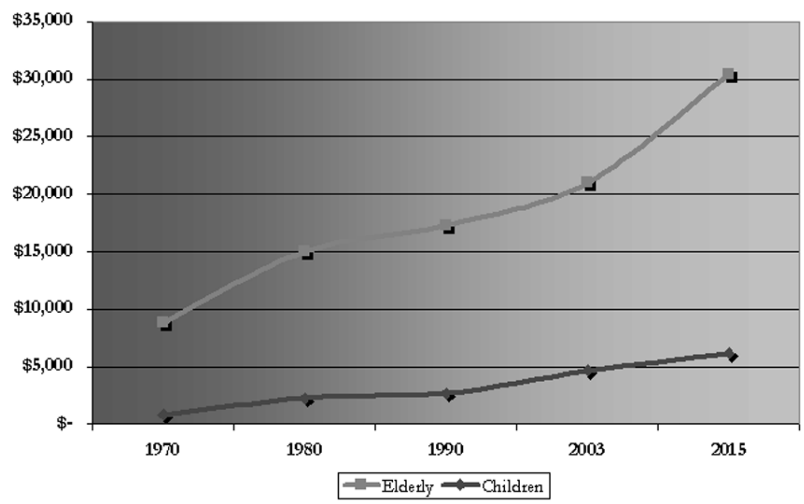
Source: Brookings Institution, based on data from Congressional Budget Office, Office of Management and Budget, Social Security Administration, and various other government agencies.

Because such fundamental reforms do not appear to be feasible at the current time, most of the downward pressure on spending resulting from efforts to restore fiscal balance are aimed at domestic discretionary programs. I recognize that Congress has made some efforts as part of the Deficit Reduction Act of 2005 to reduce spending on entitlements, but that restraint represents only three-tenths of 1 percent of total spending over the 5 years, 2006-2010.[5] In the meantime, non-security domestic discretionary programs as a proportion of GDP are at 3.5 percent and slated to shrink to their lowest level since we first began collecting the data.[6] Moreover, this is only the beginning of a continuing squeeze on this part of the government.

This squeeze will have two unfortunate effects in my view. First, it will threaten economic growth. Second, it will require too much sacrifice on the part of low- and moderate-income working families. In particular, programs serving the young will lose out relative to programs serving the old. As shown in Figure 2, per capita Federal spending on the elderly is about 4.5 times as great as per capita spending on children.[7] These figures on per capita spending at the Federal level were much closer together back in 1970 but are slated to widen further by 2015, at which point spending on the elderly will be about five times as great as per capita spending on children (Figure 3). To the extent that discretionary programs are frozen or cut in nominal terms, the resulting impact on children versus the elderly will be even greater.

Not all Federal programs targeted on children are effective. Nonetheless, well-chosen investments in children are not only a sensible use of scarce Federal resources but can also have feedback effects on economic growth and revenues, similar to what is often discussed in the context of tax cuts. Retirement benefits and nursing home care for the elderly, by contrast, have no such benefits. As an example of such feedback effects, I and my colleagues William Dickens and Jeffrey Tebbs have recently completed a detailed analysis which shows that an investment in universal preschool for all three- and 4-year-olds would initially worsen the deficit, but over the longer run would produce increased economic growth and additional revenues sufficient to more than pay for the program under a wide variety of assumptions about the various uncertainties involved.[8]

Figure 3:
Federal Spending Per Child and Per Elderly
(2005 Dollars)



Source: Brookings Institution, based on data from Congressional Budget Office, Office of Management and Budget, Social Security Administration, and various other government agencies.

I read that the Administration is planning to spend $513,000 to set up an office of dynamic analysis within the Treasury Department to determine how tax proposals affect economic growth.[9] This type of analysis is fraught with uncertainty. Well-respected economists outside of government disagree about how to do it and whether the results are meaningful. According to CBO, a 10 percent reduction in tax rates would recoup between 1 percent and 22 percent of the lost revenue through economic growth effects in the first 5 years, and add as much as 5 percent to that loss or offset as much as 32 percent of it over the second 5 years.[10] However, it would be inappropriate to claim that such effects exist only on the tax as opposed to the expenditure side of the budget.

A second reason for concern about the squeeze on discretionary programs is the likely impact on low- and moderate-income working families. Although many of the elderly, especially older women living alone, have low incomes, the rate of poverty among the elderly is far lower than it is among families with children.[11] Thus, if we must cut spending, some of the burden should fall on older Americans and not just on younger families. These issues of fairness are especially salient in light of the fact that income inequality in the United States is at an all-time high and has been exacerbated by recent tax cuts.

WHAT MIGHT BE DONE? [12]

This section of my testimony first outlines the kind of principles that might guide entitlement reform. But since real reform is unlikely any time soon, I later suggest a stopgap measure that would help to reduce the deficit very significantly over the next few years.

Principles of reform

The President has called for a bipartisan commission on entitlements, a step that I think makes good sense given the current impasse on Social Security, the lack of clear solutions in the case of Medicare or Medicaid, and the need for fundamental reform. Such a Commission-if it had the trust of both sides in the debate and a degree of independence from the Administration-could perform a real service. It's challenge, as I see it, would be to establish certain principles to guide the process and then to suggest how those principles might be translated into specific policy proposals. What might such principles look like? Let me suggest a few, without in any way claiming that these are not controversial and thus in need of far more debate.

First, I believe that health care and retirement benefits should be more related to income than they are at present. The President's proposal to raise Medicare premiums for those with incomes above $80,000 a year, and to leave the eligibility threshold unindexed, moves in the right direction. Progressive indexing of Social Security benefits would accomplish a similar goal. Tightening up on the transfer of assets to children in order to qualify for Medicaid funding of nursing home care is still another example.

Second, the retirement age at which people qualify for full benefits under both Social Security and Medicare needs to be increased and indexed for longevity. Such an increase was accomplished in the Social Security system back in 1983 suggesting that it is possible for the political system to change these rules if adequate advance warning is given.

Third, we need to move away from a system that guarantees health care and retirement benefits toward one that guarantees instead, what the government is willing to contribute-in short, from a defined benefit to a defined contribution system. This does not mean that the political system couldn't decide to increase the level of those contributions over time, but it would not leave its liabilities, as now, on automatic pilot. Nor does it mean that the level of contribution shouldn't be higher for those with lower lifetime incomes. However, individuals would be expected to contribute more to their own health care and retirement, consistent with their ability to do so. One model for such a system is the Federal Employees Health Benefits Program.

Fourth, these contributions should be mandated by the government. If they were voluntary, too many individuals would fail to save for their own retirement or health care and thus become dependent on charity or the government as a last resort. There is abundant evidence that most people do not save enough for their retirement. For the first time since the Depression, household savings are now negative.[13] And unless national savings is increased, we are unlikely to continue to enjoy the kind of economic growth we have had in the past.

Fifth, virtually all experts agree that our current health system is inefficient and too often provides care that is not worth its cost. A greater emphasis on evidence-based medicine, on payment for performance, and on a more efficient delivery system in the big public programs (Medicare and Medicaid) could be used to leverage change in the entire health care system. This could help to constrain the health care spending increases that bedevil not only Federal and state budgets, but also private employers and their employees.[14]

Sixth, taxes must be on the table. No commission on entitlements will get very far unless this is part of the deal. Just as it took Nixon to go to China, it will take more than token involvement by Democrats to revise the social contract with the elderly. And as the 2005 debate on Social Security demonstrated, public sentiment on these issues is with the Democrats. Many Republicans, for their part, fear that any increase in taxes will slow economic growth or lead to a new burst of government activism. But these supply-side effects have been much exaggerated, in my view-especially in light of the fact that recent tax cuts were financed by borrowing, almost entirely from abroad, and are not on balance good for the country's future domestic prosperity. In addition, not all tax increases have negative effects on growth. Indeed, some would accomplish just the opposite. Consider, for example, the President's Tax Reform Commission's proposal to rein in the deductibility of health insurance premiums paid by employers. This would lead to a more efficient, pro-growth tax system and simultaneously slow health care spending, and reduce one of the largest hidden (tax) expenditures in the Federal budget. Or to take another example, it would be possible to raise the income cap on Social Security payroll taxes while simultaneously lowering the rate. And a new Value Added Tax might reduce reliance on income taxes while reducing the deficit in ways that would increase long-term growth.

An action-forcing proposal

Because I am not optimistic that these issues will be resolved any time soon, I would like to share with the Committee an idea that was originally suggested to me by Robert Reischauer and which I believe has enough merit to bring to your attention.[15]

The proposal involves a temporary suspension of indexing of both benefit programs and the tax system. Many benefit programs, the largest of which is Social Security, are indexed for inflation using the Consumer Price Index, and since 1981, we have also indexed individual income tax brackets, personal exemptions, and the standard deduction.

The suspension would be put into effect immediately (FY2007) and would thus begin to stem the flow of red ink with savings in the neighborhood of $150 billion over 3 years (2007-2009). Its primary justification would be the need for broad-based sacrifice on the part of the American public to pay for the war in Iraq and the reconstruction costs associated with Katrina. Programs targeted on low-income families might be exempted. But otherwise almost everyone would be affected. Both spending and taxes would be part of the solution, making bipartisan compromise on enacting the proposal a possibility.

The suspension would be linked to the achievement of a deficit reduction goal. For example, Congress could enact a law calling for policy actions that would halve the deficit as a percent of GDP over the next 5 years with interim goals specified for each intervening year. In any year that the goal was not achieved (according to the CBO), indexing would be once again suspended for the following year (with a concomitant increase in the budgetary savings). In this fashion, the public would be brought into the process since their tax bills and Social Security checks would be affected if Congress failed to make serious progress.

A related proposal would be to simply make a technical change in the CPI to better reflect some of its existing flaws. This is a problem that is well-known among experts and has been cited as badly in need of correction by Alan Greenspan among others.

Conclusion. Short-term pressures to produce a budget resolution each year and to enact authorizing and appropriations bills may mitigate against finding long-term solutions to a budget deficit that is literally headed toward infinity, driven primarily by the growth of entitlements, especially health care spending. Thus, I want to commend this Committee for taking up the challenge and urge you to begin the process of discussing the kinds of principles that need to guide fundamental reform.

Like many others, I worry that currently projected deficits are a grave threat to our economy and that further tinkering around the edges can only postpone the day of reckoning. Even if we escape a hard landing for the economy, large deficits are likely to undermine our national strength by reducing national savings and necessitate that an increasing proportion of our future incomes be earmarked to pay back foreigners for current borrowing.

ENDNOTES

1. Office of Management and Budget, Fiscal Year 2007 Budget of the United States Government, February 2006, Tables 8.1, 8.3.

2. Congressional Budget Office, "The Long Term Budget Outlook," December 2005, Scenario 1.

3. Alice M. Rivlin and Isabel Sawhill, editors, Restoring Fiscal Sanity, 2005: Meeting the Long-Run Challenge (Washington, DC: Brookings Institution Press, 2005).

4. Alan J. Auerbach, William G. Gale, and Peter R. Orszag, "New Estimates of the Budget Outlook: Plus Ça Change, Plus Ç'est la Même Chose," January 31, 2006. Available at: *http://www.brookings.edu/views/papers/20060131galeorszag.pdf.*

5. Congressional Budget Office, "The Budget Outlook: 2006-2017," January 2006, Summary Table 1; Congressional Budget Office, "Cost Estimate, S.1932, Deficit Reduction Act of 2005," January 27, 2006.

6. Office of Management and Budget, Tables 1.2, 4.1, and 8.1

7. When state and local spending is included, per capita spending on the elderly is still almost twice what it is on children.

8. William Dickens, Isabel Sawhill, and Jeffrey Tebbs, "The Effects of Investing in Early Education on Economic Growth," Working Paper, January 2006. Available at: *http://www.brookings.edu/views/papers/200601dickenssawhill.htm.*

9. Robert Guy Matthews, "White House Calls for New Tax-Cut Analysis Unit," Wall Street Journal, Feb. 11-12, 2006, p. A4.

10. Congressional Budget Office, "Analyzing the Economic and Budgetary Effects of a 10 Percent Cut in Income Tax Rates," Economic and Budget Issue Brief, December 1, 2005.

11. The proportion of children under 18 living below 150 percent of the poverty line is twice as high (28 percent) as the proportion of those 65 or older (14 percent).

12. This section of my testimony reflects my own view only and should not be attributed to other scholars at Brookings, our trustees, advisers, or funders.

13. Bureau of Economic Analysis, National Income and Product Accounts, "Table 2.1: Personal Income and Its Disposition," 2006.

14. A more specific set of options for accomplishing these goals will be included in a Brookings volume being edited by Alice Rivlin and Joseph Antos to be published in early 2007.

15. A description of my proposal will be found in an op-ed published by the Baltimore Sun on January 27, 2006. Although I want to give credit to Bob Reischauer for surfacing this idea at a general level, I do not want to implicate him in the details of the current proposal, some aspects of which he may not like.

Mr. WICKER. Well, thank you very much, and thank you all for some very thought-provoking testimony. I expect that most of us will want to get questions in, so I will try to be as brief as I possibly can.

Let me ask a question of General Walker and Dr. Holtz-Eakin first. With regard to Medicare, from this fiscal year to the next, how much of a percentage of growth will there be in Medicare in that fiscal year, and the same for Medicaid? Can you tell me that?

Mr. WALKER. Mr. Chairman, I don't have it off the top of my head.

Mr. WICKER. We are going to need that.

Mr. WALKER. I can provide it for the record. I will be happy to.

Mr. WICKER. And also I asked staff to put a chart up, so go ahead and do that.

Well, Dr. Holtz-Eakin, are you able to tell us?

Mr. HOLTZ-EAKIN. If he keeps stalling, I will look it up.

Mr. WALKER. This is a percentage of the economy which I used in my presentation that is different than the dollar amount. The dollar amount is what I don't have off the top of my head, which is what I understand you were asking for.

Mr. WICKER. Well, let's stipulate that it will grow substantially more—that both of these programs will grow substantially more quickly than will the economy. Can we stipulate to that?

Mr. WALKER. There is absolutely no question about that.

Mr. WICKER. Now, you mentioned three things driving our long-term imbalance, but if you could, let's just focus on the factors driving this much more rapid increase in the cost of Medicare and Medicaid.

Is that a function of the cost of medical care; for example, are medical procedures in the rest of the economy growing at substantially the same rate as Medicaid and Medicare, or is it more of a function of the number of eligibles coming in?

Mr. WALKER. There are a variety of reasons why health care costs are growing much faster than the rate of the economy.

Mr. WICKER. Health care costs in general?

Mr. WALKER. Health care costs in general. Frankly, Medicare and Medicaid costs are also growing faster. One is the covered population, another is demographics, another is utilization—utilization of health care services, and another is intensity, the intensity of the types of services that are being used.

Under our current fee-for-service system, the incentives are to do more, more, more, more for two reasons. No. 1, you generate more revenue; and, No. 2, you are likely to reduce your litigation risk, because if you have done more, then you are less likely for somebody to be able to successfully sue you to say that you didn't do enough.

So part of the problem we have under our system is we don't have the right type of incentives, transparency and accountability mechanisms. I would respectfully suggest, Mr. Chairman, that the $178 billion in tax preferences for health care are fueling health care cost increases.

Mr. WICKER. Dr. Holtz-Eakin, would you care to expand on that?

Mr. HOLTZ-EAKIN. I think those are some of the key elements. Within the programs themselves, the beneficiaries pay only a small fraction of the overall costs in the form of premiums, and so if there is a large subsidy, and subsidies generally lead to a greater use of any economic item, the incentives for physicians are exactly as described where on a fee-for-service basis there is a clear incentive to raise the utilization even when you cut the fee for service. So we have seen many times where you cut reimbursements, that utilization goes up to offset and keep revenue high.

There will be more beneficiaries with baby boomers retiring, and we are expanding the coverage with the outpatient drugs, the Part D benefit, and we are mixing the low-income dual-eligible seniors into the Medicare program. So that is one reason I am more nervous this year versus next year in growth rate because of the way we are changing huge pieces, but over the long term both these programs grow faster than the economy, and that is characteristic of the health care system as a whole.

I think the key elements that everyone sees who studies this problem carefully is that cost growth is associated with new technologies. Some people say technologies drive cost growth. I don't think that is quite right, but the incentives that are set up for the innovation, the adoption, the diffusion and usage and then the utilization rate for new technologies, that is where the costs are associated. That is not a U.S.-specific problem. That is global. Everybody faces the same kind of ramp-up in their health care costs.

And I think for the U.S. to be successful, we will have to find a way for health care to act like another industry where not every technological innovation is automatically adopted and used so intensively. In some cases you can look at innovation and say, no, it is not worth it. And that doesn't happen in health, and so costs go up.

Mr. WICKER. I do notice on the chart which General Walker supplied to us, he has Medicare increasing at a much larger rate in the outyears than Medicaid. Medicare increasing at a larger rate than Medicaid. And I wonder what the reason for that would be. Eligibles?

Mr. WALKER. That and Part D. To answer your question, between 2005 and 2006, an estimated 17 percent increase in gross Medicare costs between those 2 years in large part because of Medicare Part D, but not solely because of that, and a 5 percent cost increase between 2005 and 2006.

The biggest change over the recent years in the estimated growth and cost of Medicare has been the addition of the Medicare Part D benefit.

Mr. WICKER. I appreciate that.

And let me just ask you one more quick question, General Walker, with regard to Social Security. It looks kind of flat-lined there, but I understand from your testimony that actually the cost of Social Security will grow from 4.3 percent of GDP to 6.4 percent of GDP by 2080, a substantial growth in the percentage of GDP. Is that correct?

Mr. WALKER. That is correct, but most of that growth occurs between now and 2035, and then you get somewhat of a level-off after that.

Mr. WICKER. And Dr. Holtz-Eakin, my final question is this. There has been a mention of triggers—a certain level of growth would trigger the need for Congress to adopt reconciliation or something like that.

We have been beating down these programs based on reimbursement rates when we could. What other options do we have? What are the very real, hard decisions that this Federal Government is going to have to reach to level off these very frightening graphs that we see in front of us?

Mr. HOLTZ-EAKIN. Well, there is a long list. I think the track record of cutting back provider payments, whether it be physicians with the SGR, or any of the other annual attempts to fine-tune payments, is really quite unimpressive. Most of the savings—savings that were found in the BBA 1997 have since been given back over the subsequent years, and so that doesn't seem like a strategy that is very durable over the long term.

Mr. WICKER. I think you are right.

Mr. HOLTZ-EAKIN. And so I think the alternative then is to rethink the system in a way that there is somebody who has both the decisionmaking power and the cost consequences simultaneously, and that is a hard thing to choose. We have tried that to some extent once before. We gave it to HMOs in the United States. People didn't like that very much, but that was a—you know, they were making care decisions, they had the cost consequences, and that was a strategy.

And if you don't do that, you could try doctors, capitated payments, take care of the care, will we be comfortable with that, and will we get the outcomes we want? And you can do it by making the same kind of commitment to families, make families the locus of decisionmaking, give them capitated amounts of some sort, budgets to make those decisions based on in whole or in part and see if that can bring some of the decisionmaking closer to slower growth.

But in doing any of that, we will have to address other pieces of the health care system that will make that possible to be successful. We don't know enough right now in making those care decisions. We don't know what constitutes high-quality care versus low-quality care. We don't know why practice patterns differ across the country. So we can't really do this in the standard fashion where you let people make the decision, because they don't know enough to make the decision at present. So we have to improve other aspects of the health care system in order to really get this to work in any dramatic way.

Mr. WICKER. General Walker, and then I will quickly yield.

Mr. WALKER. Mr. Chairman, the next to last slide that I showed includes a number of items that I think this Congress is going to need to consider at some point in time. Some are more dramatic and challenging than others.

As I said, I would add to this slide relooking at Medicare Part D. But, ultimately, I believe that one of the things this Nation is going to have to do, and the Congress is going to have to decide on, is a fundamental redivision of responsibilities for health care in this country between employers, individuals, and the Government.

We are going to have to have a debate along the lines of the last bullet that is up there.

Arguably, every American, no matter what their age is, no matter what their income is, no matter what their geographic location is, needs to have access to a set of basic and essential—and I underline—I put those in quotes—"basic and essential" set of health care services that would be available to them and that they know they could count on; things like inoculations against infectious diseases, certain types of wellness services that not only help them individuals, but also help to constrain costs, and provide protection against financial ruin due to unexpected catastrophic illness. Financial ruin obviously varies depending on your status. Guaranteed ability to purchase additional insurance if you want to, but either you are going to have to pay for it, or your employer is going to have to pay for it, and you may have some tax incentives through the Tax Code in accumulating funds to do that.

I think the biggest problem we have right now is——

Mr. WICKER. That would be a tax preference, wouldn't it.

Mr. WALKER. Well, I think what you could be talking about is a fundamental redefinition of responsibilities over many years as the Government assumes more of a responsibility for this basic and essential type of services to the overall population because you want to spread the risk as broadly as you can, and the Government can create the biggest pool to spread that risk. All right? But then you provide mechanisms where people can get more than that if they want, but they are either going to have to pay for it themselves, or they are going to have to get it through their employers.

Frankly, this is something that I think will probably take us 20 years to transition to, but we need to start thinking outside the box because the types of things we have been doing lately are basically trying to put Band-Aids on a system that will never be fixed with modest changes. We are going to need dramatic and fundamental reforms.

Some of the other items that I listed are things that could be done without those dramatic and fundamental reforms. For example, consider national practice standards, depending on where you live, the type of procedure that is going to be performed on you for the same type of malady is very different, and the cost and the outcomes vary widely based upon geographic location. If we could work to develop a set of national practice standards that would serve as a basis for determining what should be done, these standards could provide a safe harbor against malpractice litigation risks, could help us assure more consistency, and increase quality as well as help reduce litigation risk.

There are a lot of things that we can do that we just haven't done. Consider case management. In both the public and the private sector a lot of the most expensive costs for health care are attributable to a fairly small percentage of people, but in Federal programs we are not doing much case management. The private sector has been doing it for years. We are not doing it. In some cases not doing case management results in significantly higher costs and, frankly, poorer outcomes for individuals.

So there are things we can and should do, but ultimately we are going to have to dramatically reform the entire health care system, including a potential fundamental change in the division of responsibilities between government, employers, and individuals.

Thank you, Mr. Chairman.

Mr. WICKER. Tough options ahead.

Mr. Spratt.

Mr. SPRATT. Thank you, and thank all three of your for your excellent presentations, and provocative.

Let me ask you if you do agree with something I said at the outset, and that is that looking in the realm of what is practical, what is attainable in the near term, in the short run, isn't and shouldn't a nearly balanced budget be an imperative right now? Shouldn't we be moving toward balancing our accounts now so that we quit accumulating so much debt in light of the fact that you, as you look at that pie, everywhere in the medical care entitlements and retirements entitlements is widening, we would at least make room for and accommodate some of the widening of those ledgers, which is inevitable and won't be pared back by any number of reforms? Would you agree that the most sensible first step is to move as quickly as we can to a balanced budget?

That is a question to all three of you. Flip a coin and see who goes first.

Mr. WALKER. I absolutely, positively believe we need to move toward a balanced budget. It is one thing if our deficit is attributable to a recession or a war, but the deficits that we are running are largely unattributable to the conflict in Iraq, Afghanistan and the homeland security costs, and we are not in recession and we haven't been since 2001.

The real risk is not what we are doing today. The real risk is we face an unprecedented demographic tidal wave that starts in 2 years, when the first baby boomer reaches 62 and is eligible for early retirement under Social Security. What will happen on a status quo scenario is that will build over time. So we face large and growing structural deficits. We need to get our deficits under control, the sooner the better. But we are going to have to reform entitlements and do other things in order to deal with the longer-term problem.

Mr. HOLTZ-EAKIN. I would say it differently. I would say the No. 1 problem is the long-term spending, and that is the thing that should be the top priority.

The No. 2 problem is putting in place a tax system that the U.S. Government will be comfortable to use to finance whatever is ultimately put on the table in the way of spending. We are not comfortable with the tax system we have.

And number three would be the near-term path of deficits. Most projections over the next 5 years have debt to GDP roughly stable, deficits that look somewhere between 2½, 3½ percent of GDP. I don't love those, but I believe they are far less pressing issues than are these long-term ones, which are just absolutely threatening the economic health of the country. So top problem, top priority.

Mr. SPRATT. Dr. Sawhill.

Ms. SAWHILL. I think it is very important to set a goal of balancing the budget over a reasonable period such as the next 10 years. And we are not headed in that direction at all right now, as you know.

I think that there are several reasons why we need to make greater efforts to achieve that kind of goal; first of all, because the longer we wait, the more drastic the changes will be needed in both benefits and taxes, and the harder it will be to make these kind of reforms and restructurings that we have been discussing, and the more likely it will be that we will simply keep the current programs and current revenue system and reduce benefits and raise taxes probably with more of the emphasis on tax increases, because, of course, there will be political resistance to cutting benefits.

So the sooner we get started on this, particularly reforming the big entitlement programs, the more likely we can do it in a way that is not so painful.

Secondly, the longer we continue on our current path, the more debt we are accumulating, and the higher interest payments we are having to carry as part of each year's spending. Right now, we are spending close to $250 billion a year on interest. That is slated to go almost to $500 billion, if we stay on our current path, within 10 years. That is far more than we spend on all of the investments that the Federal Government is making right now in R&D, in education, in training, even in physical infrastructure, if you look at the projections here.

So I think that this is money that would be better spent on investing in the future, on reforming these programs, perhaps on making room for some tax cuts if that is where people's priorities are. But I think to continue as we are and to cumulate these kinds of debt servicing costs is very much to be avoided.

Mr. SPRATT. Well, let me ask you something else, if I can, because time—I want everybody to have an opportunity to ask a question.

But, General Walker, you mentioned in your testimony amongst the long laundry list of things that could be done particularly in the near term, leverage the government's purchasing power to control costs for prescription drugs.

Now, Dr. Holtz-Eakin's last employer, CBO, undertook a study of that and decided they could not—they could not certify that any savings were likely in that realm. You apparently have a different position.

Mr. WALKER. I know what VA has done, and I know the savings they have achieved.

Mr. SPRATT. Well, typically when you—and I lean toward your position, but typically when you make that comparison the answer is VA is a health care provider itself. It buys medicines for its own account, it puts them in its own warehouse, and it distributes them. And Medicare doesn't work that way, and so you can't assume that the two will achieve the same results.

Mr. WALKER. I wouldn't say that they are directly analogous to each other, but I do believe—and we have done some work on this in the past without coming up with numbers, because CBO is the one that has to come up with the numbers. Our view is that there may be potential to achieve savings that way, and we have discussed this option in issued reports.

Let me also mention one thing, Mr. Spratt, which is very important—numbers matter. I have a package for you that I gave to the chairman that has some numbers in it. You were talking about do we need to balance the budget? Part of it is how bad out of balance are we. We keep our budgets on largely a cash basis. Last year, our budget deficit, unified budget deficit, went down about $90 billion on a cash basis. Our net operating cost—the accrual-based budget deficit—went up $140 billion-plus, to $760 billion, in large part because of the fact that you have mandatory spending programs like pensions, and health care that we are not paying for today but we are accruing, and there has been a tendency on behalf of Congress to sweeten some of these benefits, especially on the military side, which ultimately we are going to have to pay for. Therefore our deficits are getting worse, not better, on an accrual basis.

Mr. SPRATT. Let me ask you one further question about another GAO study, and that was concerning what we pay per capita per patient to HMOs and other preferred providers, managed care providers, under the Medicare program. It has been GAO's finding, as I understand, that we pay more for those patients than should be paid by a significant margin, maybe as much as 15 percent.

Mr. WALKER. I don't recall the numbers off the top of my head, but I do recall the studies and the fact that in many cases we thought we were going to save money. In fact, it hasn't for various reasons.

Mr. SPRATT. If that is the case, then, the solution for health care generally is to have more managed care, less fee for service. Can we be assured that that is going to achieve the savings that you foresee and predict, or is it——

Mr. WALKER. I believe that you need to consider multiple actions, because the imbalance is so great, you are going to have to do a number of things. One of the things that is going to have to happen is that we are going to have—in the short term we are going to have to look at the perverse incentives that are created by our current fee-for-service system and the fact that about 85 percent of health care costs are paid for by third parties—players who don't benefit from the services. The people who do benefit from the services don't even see what is being billed for, they have no idea what is being billed for, and we are further desensitizing individuals to the cost of health care because it is not on your W-2 and it is not on your tax return. We just have a number of fundamental disconnects as far as transparency that create perverse incentives in the health care area.

Mr. SPRATT. Dr. Holtz-Eakin.

Mr. HOLTZ-EAKIN. This is a very difficult problem, so the notion of what would you do to fix health care underneath Medicare and Medicaid, you are going to get a cacophony of suggestions.

I think there are a couple of rules of thumb that would be useful to keep in mind. The first is to separate the decisions about care from decisions aboutinsurance. And one of the things we do in the United States is we intermix care and insurance in ways that I think gets us all muddled up.

Insurance is about the financial consequences of bad health. Care is about doctors' decisions and providers' decisions on the appropriate therapy, and the benefits of that therapy relative to the cost. So we need to make the care market work more like a market, and so there is a real benefit/cost calculation done. And if we spend more, then it will be worth it. And we may. Everyone knows that. We will be older and richer, and we can spend more. We just don't want to overspend and waste it.

On insurance, we intermix chronic care, which is uninsurable, because insurance only works if you pay a premium and don't file a claim every single year. So we intermix chronic care, which is expensive, with acute care that is expensive, and not all the dollars are equal.

We have to find a way to separate out the chronic care, which is uninsurable, so the insurance market will work. Things like that will be beneficial steps, getting that cleaned up a little bit. To sit at this table and to ask how many dollars an HMO should get in Arkansas to take care of a patient reveals how messed up we are. None of us have a clue.

Ms. SAWHILL. It seems to me it is very important to focus not only on the fact there is a lot of third-party payment going on that reduces incentives, but also a point that Doug Holtz-Eakin made earlier which is, what is driving costs here is not so much these market forces, but just the increase in medical technologies that are available nowadays—better treatment, better drugs, better diagnostic techniques—and everybody wants to take advantage of those. And it is not surprising that spending, therefore, is increasing because people want the better health and the greater longevity that that brings.

And when you look at those charts that we saw earlier, the reason that Medicare is growing about five times faster than Social Security has nothing to do with the aging of the population. Both groups' beneficiaries are growing at the same rate. The difference is that per capita spending on the health programs is growing so much faster because of this increase in the availability of treatment.

I also think that we should be careful about not attributing too much to what could be done through improved incentives, although those are surely needed. We have to remember that if we are talking about, for example, high deductible plans that would give people more of an incentive to be discerning consumers of their own care, most of the expenditures on health care aren't for routine care; they are for the more serious kind of things that are above the deductible limits and therefore aren't going to be affected by bringing market forces to bear in that way.

We also have a very complicated problem of fragmenting the insurance market so that high-risk people are left in the existing traditional employer-based system and other people are outside of that system; and costs go up in the traditional system even though there are some savings in the new, more individually oriented system.

So I just want to caution us about thinking that that can do a whole lot.

Mr. SPRATT. Thank you. Nothing further.

Mr. CRENSHAW. Mr. Mack is recognized.

Mr. MACK. Thank you, Mr. Chairman. Thank you for holding this important hearing today to take a proactive look at entitlement spending in the Federal budget. This much-talked-about, looming problem has arrived and will only get worse. I also want to thank our guests with us today for providing their insight on this topic. I appreciate you all being here, and before I get to my question, I wanted to make a brief point about the subject.

Mr. Holtz-Eakin has in the past highlighted just how much an effect the size of government spending can have on numbers of areas, and I believe he is right. As he has stated, the Government is over-extending itself in the areas of spending. This spending diverts precious resources, which could be used in other ways, to keep by the people to pursue private alternatives. Simply put, we take too much, we spend too much and we regulate too much.

It is time for us to take a look at ourselves in this Chamber and find ways to reduce spending. And I mean real reductions, not just holding the line or holding the rate of growth.

I believe last year was an important first step in this direction to lower spending, but we can surely do better. We owe it to the American people who put us here to reform the spending and budgeting process, make it more transparent and accountable. All aspects of the budget should be examined to make sure that the American people are receiving the services they need at a price they can afford. So my question goes to each one of you.

President Bush has correctly laid out a vision for an ownership society, and I could not agree with him more. In that spirit, last year I came up a proposal known as the Lifetime Prosperity Act, which would allow parents, family and friends to contribute to a 401(k) account for their children, thereby allowing our Nation's youngest citizens a chance to begin saving for their own retirement.

Studies have shown that if a thousand dollars is placed in a Roth IRA every year beginning at birth, that person would have over $2 million in savings by the time they retired, assuming the historical 8 percent rate of return.

If we are to truly save Social Security and return it to its original intent as a personal retirement supplement, I believe Congress is going to need to look at outside-of-the-box solutions such as this.

If a plan like this or a similar plan were passed by Congress, would this help to relieve some of the burden on individuals and help to curtail some of the mandatory spending? And what are some of the down sides that you may see?

Mr. WALKER. First, let me start by saying as a former trustee of Social Security and Medicare from 1990 to 1995, Social Security was not intended to be a supplement, it was intended to be a foundation, a foundation which one would supplement, hopefully, with private pensions—only about 50 percent of American workers have a private pension—and with personal savings.

I think you are right, Mr. Mack, to note that one of the other deficits that this country has, in addition to a budget deficit and others, is a savings deficit. And we had a negative saving rate last year, the first time since 1933, the depth of the Depression, and we need to do something about that.

With regard to potential savings vehicles for young people, obviously to the extent that you do that, the miracle of compounding can work for you because you are talking about a number of years. At the same point in time, we also have to recognize that that will impact the budget deficit. I mean, to the extent that we are giving additional tax preferences, we need to understand what that is going to do for us from the standpoint of economic policy and social policy, but we also have to understand what it is going to do to the bottom line of the budget deficit, and it obviously would end up exacerbating the deficit.

I think it is meritorious to think about what can be done to stimulate additional savings at as early an age as possible because with savings, the miracle of compounding works for you; when you are a debtor, it works against you. So whatever we can do to try to change that, I think would be helpful.

Mr. HOLTZ-EAKIN. I confess I don't know the details of your proposal, but I think, No. 1, you want definitely to focus on those things that would raise the national savings. That is a key issue. Make sure the economy remains growing at an adequate rate.

No. 2, I think that the way in which you integrate any such savings programs with the mandatory spending programs is actually an important consideration. You don't want to set it up in a way that if you save more and you cut the benefits off, it is an implicit tax that undoes the idea to begin with.

So how that gets done and whether it would really curtail spending in a way that is desirable is a detail that matters a great deal.

Number three, the risk associated with investment accounts is real and has to be taken into consideration. I wouldn't compound these at 8 percent, I would compound them at the Treasury rate because that is the market's recognition of risk associated with this, and that is real risk to the taxpayer. If the accounts don't pay off and the person ends up on whatever the backstop program is, and that happens for, say, a large group because of either an equity market downturn or bad economic period, that is a serious risk to the taxpayer who will have to, at a bad time in the economy, come up with the money to finance the backstop program.

So I think you ought to place the risk explicitly from the word "go," because you can't get rid of it. You can't get around it. Those are considerations.

Finally, some detailed assessment of how this fits across the income and age distribution is important. For old people there is not much time to catch up before retirement. For someone like myself, nearing the magic age of 50, but quite frankly not poor, I could probably manage it. But others are not in the same position. You have got to figure that out.

Ms. SAWHILL. I pretty much agree with what has been said. I would simply add, a lot of the tax preferences that we provided for savings haven't had as much impact as had been hoped for and yet they do lead to less national saving through their impact on the deficit.

The second thing is that in the whole issue of how to get people to save more there is increasing emphasis on the need to provide some kind of mandate, or at least a default which favors being in an IRA or 401(k), because people seem to be quite irrational or incapable of making long-term decisions about this thing. If the default is to be in the system rather than out, they will by very large numbers stay in the system and save more than they would have if they had to actually opt into the system.

Mr. WALKER. Can I mention, Mr. Chairman, real quickly, I have been on two Social Security reform panels in the past that put forward reform plans. One recommended a mandatory saving element, in the form of an individual account. I would respectfully suggest that is not a tax increase; it is forced savings, but it is the people's money, who are saving it and will get it back with earnings. You can think of a concept like that potentially as part of Social Security reform or otherwise and also think about the Federal Thrift Savings Plan as a model, with limited investment options, which frankly I wish the Congress had thought of in designing Part D of Medicare, recognizing that you can't give people too many choices or else you are going to overwhelm them.

Mr. MACK. Thank you, Mr. Chairman, and thank you for your answers.

Mr. CRENSHAW. Mr. Moore is recognized.

Mr. MOORE. Thank you, Mr. Chairman, and thanks to our witnesses for being here.

General Walker, I heard you talk earlier just now about Medicare Part D and the choices that seniors have under the new prescription drug plan, and you cited a figure in your first testimony, and I didn't write it down, about the cost over several years of this Medicare prescription drug benefit. Do you recall?

Mr. WALKER. $8.7 trillion invested at Treasury rates as of January 1, 2005, to deliver on the promise for the next 75 years.

Mr. MOORE. On January 31, 2005, my friend, Ms. Emerson, who is on the other side of the aisle, and myself filed a bill called the Meds Act, H.R. 376.

This goes back to what you said earlier too, sir. Back in 1992, I believe, the Congress passed a law that gave the Secretary of Veterans Affairs the authority to negotiate a group discount with the pharmaceutical companies. This bill would give specific authority to the Secretary of Health and Human Services to negotiate the same kind of discount. The veterans I have talked to are very pleased with their benefit.

The seniors are very confused about this new law and very concerned that they are not going to get what they hoped to get under this law. I think this would greatly reduce—and I am not saying it is going to go all the way to $8 trillion—but would greatly reduce the cost of the Medicare benefit being provided right now and would give a similar benefit the veterans have had and enjoyed for several years.

Any comment, General Walker?

Mr. WALKER. Sir, I would have to take a look at the bill, and I plan to do that. We have done work, as I mentioned before, on the VA's program; and I understand it is not directly analogous to Medicare, but I do think savings can be achieved through leveraging purchasing power.

Mr. MOORE. I have another bill that I filed in February of 2005, and this is a bill called the Social Security Truth in Budgeting Act. What this would do is take Social Security receipts, funds, taxes out of the unified budget.

I talked to a friend of mine across the aisle and said, I have heard you talk about fiscal responsibility; I know you believe that and you want that; you should sign this bill. He said, There is a problem; it will make our deficits look even larger.

I said, That's calling the truth to the American people.

I want to give a copy to each of you too.

Finally, last thing, the President and Members of Congress have talked about permanent repeal of the estate tax. I tell my folks back home, it doesn't have to be all or nothing. We talk all the time about trying to protect small business and the family farm, and I filed a bill on this that would have, instead of permanently repealing the estate tax, raised the exemption to $3.5 million which would, I understand, protect over 98 percent of the estates in this country. And I understand, also it would cost $200 billion less over 10 years than total repeal.

So I ask my friends across the aisle to take a look at some of this. It doesn't always have to be all or nothing. We can protect a great, great majority of people and estates in this country without bankrupting our country or putting our country more in debt.

General Walker.

Mr. WALKER. I think one of the things Congress needs to definitely consider, given not just our current deficits, but our projected, long-range, growing structural deficits, is to target better, not just with regard to issues like the estate tax, but also with regard to issues like, should all health care coverage be excluded from taxation or only up to a certain amount? Should entire home mortgage interest be deductible or up to a certain level?

I think we are going to have to start thinking about some of those concepts, given the hole that we are in and the rate that we are digging.

Mr. MOORE. Thank you.

Any comments from any other witnesses?

Dr. Holtz-Eakin.

Mr. HOLTZ-EAKIN. I can't resist picking up the comparison of the VA to the Part D benefit. This is something I have looked at pretty carefully. The VA is very different. It is a large provider that does a lot of training, has the ability to promise pharmaceutical companies that they will train docs using their drugs, and that is a tremendous appeal, allows them to negotiate great bargains.

It has a very restrictive formulary, and it is take it or leave it, and only one in six takes it from the VA. So they have got a select population taking that particular formulary which is delivered at a very low cost because of their unique position.

Mr. MOORE. Let me stop you just 1 second. The last day he was in office, Secretary Tommy Thompson said when he was asked if he had any regrets, he said, I wish I had had the opportunity to negotiate for a group discount.

Mr. HOLTZ-EAKIN. That may be, but I think the key here is that the Medicare population is very different and it is not a select population, so you really can't do this comparison that way. The VA is, in fact, one of the reasons why I think the general competition in Part D is effective. It looks like one of these big nationwide folks; not everyone has to go to it, but if there are a bunch competing, you get this pressure to have both the tools, the formularies and the incentive, the profits, to keep prices down. That has been the logic from the beginning.

I think, given that, you want some choices. Choices are a good thing. I would remind everybody that this benefit is a big expansion in the program, for better or worse, and it is a couple of months old. It is going to take a little while for this to shake out, and that is just a fact.

Finally, the big design issue, I think, in the Part D benefit is that there is a line between outpatient therapy called "seeing the doctor" and outpatient therapy called "taking your meds," and those ought to be on a level playing field. What is the difference between a therapy which is done through pharmaceuticals and done another way?

We need to get rid of those kinds of artificial walls so that therapies compete on the basis of their merits. That would be something to think about.

Mr. CRENSHAW. Mr. Chocola is recognized.

Mr. CHOCOLA. Thank you, Mr. Chairman.

It seems to me, in order to solve problems, we have to define. I haven't been in Congress that long, but we are a reactionary or responsive body. We tend to focus on things we hear our constituents talking about at home.

I don't hear this issue come up at home very often. In fact, I hear the opposite. I don't hear we have got to find a way to reform entitlements. We have to expand entitlements for many of my constituents. We don't see it on the evening news. I would venture a guess that if the Federal Government was a public company and it had the financial challenges that our government has, it would be on the news every single day.

So my question is, even though there are various government reports that outline this problem, what kind of tools can we use, what kind of communication methods do you think we can use to get the American people to understand the magnitude of this problem and start talking to us about it in our town hall meetings, to make sure we address it and they hold us accountable if we don't sooner rather than later?

General Walker.

Mr. HOLTZ-EAKIN. I want to do one thing. I went and gave a speech in Dallas just before I left CBO to a great group, civic leaders, very concerned about the problem. I told them, and they said, Why isn't anyone saying anything? I said, That is all I do.

So it is absolutely true, the people haven't heard it and you have in front of you two of the leading experts in trying to get the message out. I will let them explain it.

Mr. WALKER. Let me tell you what is being done right now and some other things I think need to be done, because you can't solve a problem until a majority of the people believe you have a problem that needs to be solved and it is prudent to solve it sooner rather than later.

We are talking about a problem that is so huge that very painful choices are going to have to be made that will not be politically popular, and therefore my view is, given that fact and given the fact that most people in Congress want to come back after the next election, then the ground has to be tilled, not just within the beltway, but more importantly outside the Beltway to help the American people understand where we are, where we are headed and what the adverse consequences are for our country, for their children and grandchildren if tough choices aren't made sooner rather than later.

Now, in that regard, Isabel Sawhill and I, and a number of others have come to form what I call the Truth Squad, which has been conducting town hall meetings in different cities around the country to go directly to young people, to go directly to seniors, to go directly to business leaders and others to help them understand where we are and where we are headed.

We have been to four cities already—the latest was Atlanta. We have eight others scheduled. We have about 15 others on the waiting list who want to be part of it. More and more groups are becoming part of this coalition every day.

It includes an interesting mix of partners. For example, the Concord Coalition, Association for the Advancement of Retired People (AARP), the American Institute of Certified Public Accountants (AICPA), the Heritage Foundation, the Brookings Institution, the Committee for Economic Development, and the Committee for a Responsible Federal Budget. Many major colleges and universities around the country are part of this. That has to happen.

Another thing that has to happen is, I think some of the things that I have suggested on the last slide that I gave you need to happen, but we also need to have a summary annual report for the U.S. Government. We did this when I was a trustee of Social Security and Medicare from 1990 to 1995, and I have been talking with the Secretary of the Treasury, John Snow, who is chairman of the board of the Social Security and Medicare trustees, and Josh Bolten.

I am the auditor of the financial statements—GAO is, and I sign it. What I would like to see ideally, for this next year, short, plain-English charts and graphs, bottom-line documents like we have been doing for Social Security and Medicare since the early 1990's that could receive broad-based distribution, that could be used to help people where we are and where we are headed. We are not going to solve the problem until you have over 50 percent that believe it needs to be solved, and it is prudent to do it sooner rather than later.

Ms. SAWHILL. I won't repeat what David Walker has just said, but we are working hard on getting the word out to the public. I think that we have also done some efforts to look at what brought Congress together in the past when we had other kinds of fiscal crises, whether it was Social Security in 1983 or tax reform in 1986, or the various budget agreements in 1990, 1993, and 1997.

If you look at that history, what you find out is that several things were always required. One was, you had to have leadership from the White House. Secondly, you had to have bipartisanship, although in 1993 we did not, but in most of these cases we did. Thirdly, you had to have the public concerned for one reason or another.

Ross Perot put this issue on the table in 1992 that required that Clinton address it when he became President, given how well Perot did with the issue in that election.

And I think that a lot of us are concerned that what it is going to take is an economic or financial crisis of some sort, and we are trying to get the public to attend to this before that happens, but it may not. And I think there is a real threat to the economy.

When we talked earlier about why should we be focusing on reducing the deficit now rather than later, the major reason, in addition to some that we talked about earlier, is because this could lead to a crisis.

Foreigners are lending us basically all of the money, almost all of the money that we need right now to cover these deficits on an incremental basis, and at any time they could decide not to lend us those dollars and that could lead to very severe consequences for the economy. Everyone has talked about that, in addition to the three people up here. Alan Greenspan is, I think, increasingly concerned about this, as are many others.

So I like your question. I think it is very important that we get the word out, and I hope all of us can do that together.

Mr. CHOCOLA. Thank you. I wish you luck on your tour. I offer my help in any appropriate way, and I look forward to a town hall meeting, that I have several hundred people screaming that we need to reform our entitlement systems now rather than later.

Mr. Chairman, I yield back.

Mr. CRENSHAW. Mr. Neal.

Mr. NEAL. There will be screaming, and as long as you can keep it general, you will survive.

Mr. Eakin, I listened to your analysis of the budget challenge on Fresh Air. You did a great job and it is always nice to have panelists on the other side, free of the day-to-day political pressures that many of us feel.

And forgive me if I am a bit skeptical of the tour, largely because of timing; I think that timing is going to be critical to this dispute.

While we are on that topic, let's give credit to Bush One. I was here when we cast a pretty tough vote—the Republican leader of the House helped to get the votes to get it done—and two successive achievements by the Clinton administration where people said it couldn't be done.

Not only did we get it done, there was unparalleled economic growth. Nothing in the last 5 years comes close to that, during those years, after many naysayers said it couldn't be done.

But there was something interesting in one of the small newspapers over the last couple of days. There was a member of the House very upset that his request for earmarks had been, as he deemed it, "leaked." he said that they had been leaked. Some of us would say, Look, if you don't want to be known by the spending, then don't request it. That is the easiest way to resolve this issue rather than what has happened around here where friends on the Appropriations Committee on both sides tell me frequently that the people who make the most aggressive requests for spending—and, by the way, hold the most anger for the longest period of time—are frequently hollering and screaming about spending.

I think Mr. Nussle and I discussed this in the past; the easiest way to get it done is to have everybody's letters published and their requests for spending. Mr. Nussle said, Look, we all know you can't grow your way out of this problem.

$257 billion for defense during the middle of the Clinton administration, the cuts had begun during the end of the Bush administration with the collapse of the Soviet Union.

Now we are at $439 billion. Homeland security, $40 billion; the prescription drug bill, $740 billion after we were all assured it was going to be $400 billion of spending; Hurricane Katrina; two wars where everybody knows we are going to be there for a long period of time; and the $60 billion suggested by Mitch Daniels really doesn't stand up under analysis.

But my point is this. If we are going to do this, you can't have commissions that are appointed where certain things can't be on the table. That is not going to be a discussion. I would advise Democrats, don't participate if everything is not going to be on the table. And instead we are being told that the confines of the debate are limited to certain prescriptions offered only by the administration in some sort of a litmus test.

Let me ask the three of you this. I assume, based on your comments today, that most of you—your comments on that show, Mr. Eakin—you really don't support the notion that tax cuts actually increase revenue.

Mr. HOLTZ-EAKIN. No, I don't think tax cuts pay for themselves. I mean, tax cuts—not all tax cuts are created equal. I am nervous when people talk about tax cuts blankly. There are clear economic responses to good tax policy. They offset some of the static revenue loss, but they don't fully pay for themselves; and I think that one of our challenges in the years to come is to have a tax code that we can use to pay the bills.

The current Tax Code is riddled with so many inefficiencies that I sense no one trusts to use it. We really do need to fix it.

Mr. NEAL. Any other panelists?

Mr. WALKER. I think people get confused. Not all tax cuts stimulate the economy. Some are economically driven, some are socially driven. Very, very, very few tax cuts pay for themselves.

I have said this many times before: If we are bleeding on the bottom line, we need to consider both sides of the ledger as it relates to future legislation.

Now, by not considering the potential costs and consequences on the tax side, including tax preferences, that leads to very perverse actions such as back-door spending through the Tax Code because you can't do it through the front door.

Let me just say about the proposed commission, whether or not that commission would be successful depends primarily on two things: First, who is on it; they have to be people that are capable and credible, not just on one side of the aisle, but both sides of the aisle. And, number two, no preconditions about what is on or off the table.

If you don't meet those two conditions, and I can probably come up with others, then it is probably a waste of time.

Mr. NEAL. Dr. Sawhill.

Ms. SAWHILL. I would very much agree with what was just said. Just as it took Nixon to go to China, I think it is actually going to take, primarily, Democrats to make the kinds of changes in the big entitlement programs that are going to be needed in the future. So this has to be bipartisan, and it has to be a trusted process.

On the tax issue, I think that the structure of the tax system is every bit as important as the level of taxes. Earlier we talked about tax expenditures, hidden subsidies, hidden expenditures, or "back-door spending," I think they were called.

Think about the amount of money we are spending on health through the tax system in terms of exemptions for individuals and employers in the current system, and that is a lot of money; and that helps to drive up health care spending and add to the problems we talked about earlier.

The President's tax reform commission proposed to cap that tax preference. The current administration seems to be going in just the opposite direction.

So this is an interesting issue that I think you all ought to look at. This is very big dollars and part of the health care spending problem that we discussed earlier.

Mr. NEAL. Thank you, Mr. Chairman. That has been very useful.

Mr. CRENSHAW. Mr. Garrett.

Mr. GARRETT. Thank you, Mr. Chairman.

Thank you, panel.

Just going back to an opening comment by Mr. Spratt with regard to the need for a balanced budget, this reminded me of a conversation where I had a family who said, they have not seen their family income go up for the last couple of years—no raises and what have you—and the question came up, if the Federal Government operated that way, froze everything—not just discretionary, froze everything across the board, how long would it take us to actually get to a balanced budget.

Do you have a number that I can go back to them on? I have heard around 3 years, around 3 years if you froze everything across the board. Probably not a realistic goal for considering we try to use mandatory by less than 1 percent and we got into a lot of trouble for that.

Ms. SAWHILL. But consider that the proposal that I described earlier does something less draconian than that, but has similarly large effects and might be considered fair.

Mr. GARRETT. Might be fair but goes back to your comments about getting the other side to do it. Because as soon as we talk about reducing benefits not for current recipients, but recipients potentially down the road, I can tell you it was not necessarily well received in some quarters.

Mr. WALKER. I can tell you for sure that irrespective of what the number—probably three to five, off the top of my head, back of the envelope—one, you know that would be extremely difficult, if not impossible, to do; but secondly, it doesn't deal with our long-run structural imbalance because it doesn't really start—in earnest until 5 years from now when the first baby boomer reaches 65 and is therefore eligible for Medicare.

And that is the real problem. It is not the short term. The short term is a problem, but the real problem is the large and growing structural imbalance.

Mr. GARRETT. On the short-term side, I heard you make the comment, if you wanted to solve it on the taxing side, we would have to see an unprecedented increase in the level of taxation.

Now, I have also heard in debates on the floor that all we really have to do is go back to our tax rates of the prior administration before the GOP came in. If we went back to those rates, across-the-board rates would go up. Would that solve our problem if we raised the rates prior to this administration?

Mr. WALKER. No.

Mr. HOLTZ-EAKIN. Not close.

Ms. SAWHILL. No, it would not.

Mr. GARRETT. Thank you.

Next question: I come from——

Ms. SAWHILL. Depends on the time frame. But if you are talking, looking out to 2030 or something like that——

Mr. GARRETT. I come from the great State of New Jersey where we consider ourselves a donor, State and by that, I mean at the end of the day we send out more to Washington than we ever get back. This has been the history of New Jersey for a long time.

On the upside, we are an affluent State and generous State, although I am waiting for thank-you notes from the other States.

My question is, if we were to get entitlement reform in one shape or another, is this good for my State and can I say we are not paying out as much money or that we are not subsidizing the rest of the country as opposed to some of my constituents, and say, Don't cut any of my benefits?

How does it impact a State such as New Jersey?

Mr. HOLTZ-EAKIN. I think the key here is, regardless of whether you are a donor or recipient State, that is a measure for which I have relatively little sympathy, quite frankly. This ship will go up or go down, and if you don't fix entitlements, it is likely to really damage the overall economy. New Jersey will be damaged right along with it.

So you should tell your constituents, If we would like, regardless of our donor status, to continue to have the capacity to donate at all, you have got to fix entitlements.

Mr. WALKER. Another way to look at it is, if you look at one of the graphics that I showed about the long-range imbalance, under the second scenario you would have to more than double Federal taxes alone, in order to deliver on the promises that government has already made in about 2030-2040. You would have to increase it; but by that point in time you would have to more than double them. That would have a tremendous adverse effect on economic growth, on disposable income, et cetera, et cetera.

That is the one I am talking about there, (Figure 3) by 2040. The way I get there is, look at the bar, which is spending as a percentage of GDP, and then look at the line, which is revenue as percentage of GDP. If you said we are just going to tax, we are not going to change anything, just tax, then the line has got to match the bar if you are going to break even. That is more than two times higher. That doesn't count State and local taxes.

On the other hand, if you cut back government to everything that is only literally referenced in the Constitution—literally not arguable, literally referenced in the Constitution—and you did it soon enough, you might be able to get there.

That is not realistic either; that is why I say three dimensions: entitlement reform, restructure both discretionary as well as other mandatory spending, and tax policy. You want to minimize taxes for economic growth, disposable income, competitiveness, and a lot of reasons, but you are not going to get there without, over the long term, having a higher percentage of revenues as a percentage of the economy than we have right now.

The great debate is going to be, how much can you get from entitlement reform, how much from spending restructuring restraint, and what is the plug. Hopefully, the plug is as small as possible, because over the long term you have got to be able to pay your current bills and deliver on your promises, and we are not anywhere close to being able to do that.

Mr. GARRETT. Do you do an analysis of whether we are within the confines of the Constitution on all the items that you cover in your report?

Mr. WALKER. Some of the items in discretionary spending are in the Constitution but some mandatory programs are not.

Mr. CRENSHAW. Ms. Schwartz.

Ms. SCHWARTZ. Thank you very much.

I did want to ask a little bit about Medicare Part D which we are in in its first few months and you talked about both short- and long-term costs. But I am interested in whether my constituents and seniors are getting what we are paying companies to provide them.

I am sure you are aware—I think this is mostly a question for General Walker, but aware of the fact that there have been some serious problems in the initial implementation of Part D. Some were concerned about long-term problems, but the immediate beginning, I certainly won't speak for other Members of Congress, but I have heard from my constituents—particularly individual seniors who had to pay out of pocket and then were told they would get reimbursed, or hope to get reimbursed, heard from pharmacists who provided needed medication and are hopeful of getting reimbursed; and, of course, the whole issue of the States and whether they will actually be reimbursed.

So my question really is, we are paying companies to provide this benefit and there have been real problems in people not getting medications, seniors not getting this medication. Just this week Secretary Leavitt said that, in fact, it is not going to be the responsibility of the administration to demand or expect that the companies we have sent taxpayer dollars, to provide this benefit to reimburse seniors, that it will be up to individual seniors to seek reimbursement. They are completely on their own.

I am outraged by that on behalf of my seniors. I think my seniors will be outraged. And, again, I am not even talking about the pharmacists or States. The administration has indicated they may, in fact, take new tax dollars because they are not going to insist companies pay for benefits that they should have.

The interesting thing about that is not only my outrage and the fact seniors will be out some money, but the fact is that just 4 days ago, or 4 days before Secretary Leavitt made this pronouncement, his own Department put out a regulation that said, in fact, we would be insisting on overpayments.

We have paid the companies to provide the benefit. If they are not, in fact, fairly reimbursing or paying for that benefit, there must be a process, as regulations say it—I have it in front of me if you haven't seen it yourself—that, in fact, those companies have to have a process of doing this.

So he is already saying he is not going to hold these companies to account for his own Department's regulations. That is really unacceptable that we are not only spending a lot of money, but in fact, are not going to hold those companies accountable for providing those benefits to seniors.

Could you speak to the role the GAO will play in making sure that the administration holds the Department—these private companies accountable for these tax dollars to be paying benefits to seniors? And how quickly will you be doing some oversight to make sure that that is happening so that we are getting what we pay for, and most importantly, the seniors on the street, trying to get their medications that they need?

I think most people are not taking medications they don't need. They are paying out of pocket.

Mr. WALKER. First, let me say that there are three primary problems with Medicare Part D. One is design, another one is administration, and the third one is fiscal, we can't afford it. I expect that we will be doing work on this.

At GAO we are way oversubscribed for work in our health care area, way more demand for work than we have supply to do it. But given the concerns that I have heard, including the ones you have mentioned, I have little doubt we will be doing work in this area.

At the same point in time, we want to coordinate what we do with the other accountability players. For example, HHS has a very large inspector general operation, if you will, and I would want to make sure whatever we do is coordinated with what they are going to do.

So let me find out whether or not we have had any requests, anything under way, and I will get back to you.

Ms. SCHWARTZ. Do you need a request in order to take some action on this?

Mr. WALKER. We need a request from the committee with jurisdiction over the matter, typically, Chair and/or ranking member because of our supply and demand imbalance.

Ms. SCHWARTZ. I am neither of those, but the letter that I have addressed to Secretary Leavitt about the fact that this is of deep concern that he would make such a statement, that he would not demand this performance.

I would also ask you, in my 4 seconds left, to take a look at, similarly, the concern that I have that there might be companies that actually might scam seniors. Hopefully, we haven't seen that yet, but I have introduced some legislation that would call on your office to actually help make sure that we do not have seniors being offered by companies that don't exist, or offering the benefits. There are so many options out there that I think this is ripe for that kind of scamming.

So if you could, put that on your list of concerns to take a look at as we go forward.

Mr. WALKER. I can tell you, in addition to our normal audit evaluation capabilities, we also have a special investigations unit; and I fully expect that they will be doing work with regard to Medicare Part D, whether or not we get a request.

Ms. SCHWARTZ. That I appreciate. Thank you.

Mr. CRENSHAW. Mr. Conaway.

Mr. CONAWAY. Thank you, Mr. Chairman.

And thanks everybody for being here today. Appreciate that.

By professional background, I am a CPA, spent about 30-plus years helping taxpayers comply with an incredibly complex code; and I agree with all the comments about, it is unworkable. I would like the challenge, though—and this is my observation, and I don't necessarily need a response back. But this concept of "tax expenditure"—words mean things, and in the real world, those don't.

Inside the beltway they have great meaning and everybody understands it, but when I sit down with taxpayers and prepare their tax return and I have shown them a difference between what their tax would have been under particular circumstances, whether they took advantage of a particular piece of the Code or whatever, it would never occur to them that the Government owned that money, first, that everything they made, all the earnings off the sweat of their brow, was actually theirs and that the Government was trying to take a part of it and that because the Code got changed and the Government didn't take a piece of it, that somehow the Government was owed that money under some empirical system that said everything we do and all the hard work we generate, the Government owns it and we are going to leave you a little piece of it.

So to the extent you want to defend tax expenditures under that concept, you will have to tell real taxpayers everything they earn and all the sweat of their earnings belongs to the Government, first, and that in our graciousness, we will leave them some of it.

David, you and I had a conversation about total debt. You may have mentioned it earlier, but give us a magnitude. Last number was like $44 trillion. What is the current number?

Mr. WALKER. The total liabilities and unfunded commitments, this is just for 75-year costs, came to $46.4 trillion as of September, 30, 2005.

Mr. CONAWAY. Is that impacted by the accrual-based deficit we ran, or in terms of an all-in number on a balance sheet, the liability side of a balance sheet; is that the number?

Mr. WALKER. The accrual-based number would even be worse if we considered Social Security and Medicare, because they are not in there. That accrual-based number, the reason it is so much higher than the cash-based number is for things like civilian and military pensions and retiree health care.

Mr. CONAWAY. These are numbers that aren't make believe. These are actuarially assigned debts and liabilities. Where they have a private company or pension plan you would have to account for them as actual expenditures.

Mr. WALKER. These appear in the annual report, but you have to go to the MD&A, the financial statements, and the footnotes and pull the numbers from several different places; and that is one of the things that we need to change in this summary annual report. Bring it all together, make it concise, make it clear, translate it into terms Americans understand, like $156,000 a person, $375,000 per full-time worker.

Mr. CONAWAY. As an aside, would somebody in the government be as responsible for signing those statements as a CEO, CFO of a publicly traded company?

Mr. WALKER. The CEO doesn't sign these statements; that would be the President of the United States.

Mr. CONAWAY. That was a rhetorical question.

Mr. WALKER. I understand that.

Mr. CONAWAY. We hear an awful lot, and Ms. Sawhill mentioned it as well—I used to be in the banking business in a prior life, and the old adage, If you owe the bank a thousand bucks, the bank owns you; but if you owe them a million bucks, you own the bank.

Which is more of a concern to us, the actual level of debt of this country or who owns that debt? Which would be a bigger issue with you, any of the three of you?

Ms. SAWHILL. Well, I think they are both important, but I think the fact that so much of this is now owned by

foreigners is a new concern that we haven't seen in the past and the growth in the amount of the debt, or the proportion of the debt owned by foreigners, has been going up very rapidly, and this can begin to impact not just our economy but also potentially our foreign policy and our relationships with other countries.

Mr. CONAWAY. Why would these countries not operate in their own best interest, the way investors would operate who weren't countries?

Ms. SAWHILL. I think they, most of the time, will operate in their self-interest, but their interest may include such things as making sure that, in the case of China, they have strong export markets because that is the way they produce jobs domestically. And so they have the same kind of political pressures, so to speak, that we do to make sure that their domestic population is employed, that their exports are strong; and that creates a different incentive than would exist for a private investor.

Mr. CONAWAY. It would not be in their best interest, or would be, to have a major devaluation of that debt? That would be in their best interest to make that happen?

Ms. SAWHILL. No.

Mr. HOLTZ-EAKIN. I don't think that is the scenario to worry about. I think the concern really isn't about the current level of competition; it about the prospective growth in this debt and the fact that largely that would accumulate outside the United States. That has consequences for flexibility from a pure financial point of view. It has consequences from the point of view of standards of living.

I don't think there is a scenario in which a self-interested foreign entity would dump U.S. securities in a way to try to cause a crisis. That doesn't appear plausible to me. It does seem to me that it remains a concern because of the fact that if you are in that position and something else happens, whether it be an international price move or something like that, you are going to have more trouble. That is the main concern.

Can I take a shot at the other two things? I think you should not—I argue with him usually. I think it is nice to bring in these measures as a complement to the basic budget, but the cash flow budget is a management tool. Discretionary budget authority is the way you control what the government does. Mandatory budget authority could be controlled in the same way. That shouldn't be lost in this discussion about disclosure of the financial condition, with which I have some sympathy.

On the issue of tax expenditures, it is not about take the labeling out of it; but it is not really an issue of how much dollars, it is about how effectively they are raised. And by leaving things out of the tax base, you are forced to have high rates elsewhere, in many cases on things that you don't want to tax if you want to grow effectively.

So the notion should not be as raising revenue, but broadening the base to have a better tax system. That is the key.

Mr. WALKER. Words matter and tax expenditure is a Washington, DC, term and not one I used when I practiced as a CPA for many years.

To answer your question on debt, that is probably the most important factor to keep in mind, not just where we are, but more importantly, where we are headed.

Secondly, the foreign dimension is a different one. Obviously, you don't expect for investors, including holders of our debt who might be foreigners, to act in a way that is adverse to their interest.

Here is my concern. We have gone from a relatively small percentage of our debt being held by foreign players to almost half. Within the last couple of years foreign players have purchased an amount almost equal to all of our new debt. Now—one of the reasons being, we had a negative saving rate last year and we had one of the worst household saving rates of any major industrialized nation on earth. So we have to rely on foreign players to fund our deficit.

My point is this. Let us just suppose that because of a simple principle of diversification, which we are all familiar with in investments and other concepts, they decide that they are not going to dump it or not going to buy it, but they are not going to buy it in the same relative volumes that they have in the past. That in and of itself could cause a problem. Where are we going to get the money and at what interest rate are we going to pay?

Mr. CONAWAY. My time is up, but that is the level of debt that is the ongoing issue.

Thank you all very much. I appreciate it.

Mr. CRENSHAW. Thank you.

Let me ask before we go to the remaining two members—let me ask you a question about the difficulty of this whole entitlement reform. Everybody—for any number of reasons, we know how hard it is. It is complicated. People don't understand it, and we don't do it very often. We tried it in 1997, last year; and it was very, very difficult. We achieved some reform.

And so there is a school of thought that believes that maybe if we try to do reconciliation every year, maybe in a smaller piece, not just undertake an overall reform, but pick and choose, it seems to me, number one, it might help educate the world out there that aid you in your efforts and all our efforts to say, we have got a problem. And when we talk about deficit reduction, we begin to get the picture.

But even doing smaller amounts every year seems to be—that inherent problem, medical programs might need more refinement from time to time.

Can you comment at all on just the question of maybe we begin to direct our efforts to this difficult problem on a—just from an educational standpoint, maybe for members to kind of get in the habit of remembering how much we have to do and begin to do it little by little, every year, instead of waiting every 8 or 10 years and then trying to take on something that doesn't really do much good? Can you comment on that?

Mr. WALKER. First, I think we have to educate both within the beltway and outside the beltway about the magnitude of the overall problem and the consequences of inaction. But then from a practical standpoint, I think we are going to have to deal with it on an installment basis. There is no question about that. The problem is too great. This is not just the Budget Committee. It is also the authorizing committees, the oversight committees, and the appropiations committees.

One of the biggest problems we have, as I mentioned before, a vast majority of Federal Government policies, programs, functions and activities and even its organizational structure, classification compensation systems are based on the fifties and sixties, and we need to start looking at these and to reengineer them, reprioritize them for the 21st century, and I would argue that every committee of Congress ought to be doing that for the policies and programs that are under their jurisdiction. They ought to set their agenda as to which ones are the most important and to start ticking them off a little bit at a time toward achieving an overall goal.

Last thing on Social Security: Social Security is simple to reform. The primary reason the reform effort failed was because the process was fundamentally flawed. For any major transformation effort to succeed, whether it is inside an organization or a public policy, you have to have three things. You have to have principles that frame the discussion of the debate and help people see the way forward. Secondly, you have to have players who are viewed as being credible within the population and on both sides of the aisle. You have to involve both opponents and proponents to try to determine what an appropriate solution is. Thirdly, ultimately you have to have a proposal that can be considered for action.

While I think the President deserves a great deal of credit in recognizing that it is better to reform Social Security sooner rather than later, and he spent a lot of his personal time and effort as others did, the process failed on all three points.

He didn't have the right portfolio of principles, he didn't have the right players, and he didn't ever generate a proposal. As a result, there was not going to be action. If you look back on what happened in 1983 with Social Security reform, you met those criteria.

Mr. HOLTZ-EAKIN. That is a really hard question. No question about the difficulty of doing this. I don't think you should pick. I think one should recognize that this committee and the budget process in general is an exercise in implementing underlying policies and that fundamentally these policies have overpromised over the long haul, and so it will be necessary to rethink the scale of those promises and how we do it. And then the budget process will implement whatever new policies we may ultimately adopt.

In the interim, doing reconciliation every year will educate people. If you look at the scale of effort, which simply cannot be understated, that went into cutting under 1 percent of mandatory spending over the next 5 years was enormous, and I think the members in this committee know far better than I do what they went through. Their constituents need to learn that really, despite all that was said, nothing has changed, and that education process every year would be important. But you won't get there just doing that, I don't think. If it is done that way, it becomes just a budget cutting exercise.

That sounds unpalatable to the ears of the constituents. They need to understand that there is a policy that will work for the long run, not that you are just going to keep taking something away without any particular guidance as to why. So I would do both, but reconciliation is here to stay as near as I can tell.

Mr. CRENSHAW. Ms. Sawhill.

Ms. SAWHILL. I very much agree with what Mr. David Walker said. I would be worried about putting too much emphasis on doing this year by year as part of reconciliation. It seems to me that that is a political death by a thousand little cuts, and it is very difficult to make very much substantive progress.

The reconciliation bill that Congress struggled with this year that cut $40 billion over 5 years, that is three-tenths of 1 percent of total spending. So it sounds good when the media writes about it, but it doesn't really put more than just a tiny nick in the problem if you are worried about spending.

So it seems to me you have to begin the process of fundamental reform of these systems, and that is going to require bipartisan agreement. And Social Security I agree is the place to start. There have been many ideas put on the table, and I think a compromise is possible there. All we need to do is just do it. I understand that is politically hard. It is not as if the policy ideas aren't there to do it.

Mr. CRENSHAW. Thank you. It is kind of discouraging to hear that Social Security is the simple one. I don't know where the hard ones are. But Mr. Cooper, you have——

Ms. SAWHILL. Medicare.

Mr. COOPER. I apologize for having to step out, but the meeting I went to was on the budget as well.

You all come from different walks of life, but we have before us today three of the most talented and capable public servants our Nation has ever seen. I just wish there was more of us to listen to your message and take it to heart. Because here we are the Budget Committee. There are a handful of good-hearted members present. I think we have 6 legislative days left until we draft and pass a budget for the United States of America.

As I understand it, if our biggest problem is Medicare, we will not even hear testimony from the Secretary of HHS or the head of CMS prior to our drafting our budget proposal this year. It will probably be acrimonious as usual when it shouldn't be because we should all be working together for the good of the country.

It is shocking how the budget process has deteriorated and how probably they are not 30 Members of Congress who could give even a ballpark estimate of what it would take to fix Medicare or pay for AMT relief or some of the other questions that we should be dealing with.

So I appreciate your willingness to be the Paul Reveres of your age. I just worry that people aren't really taking the message to heart. I want to ask three questions. I think we would be better able to warn the public if CBO numbers were more realistic.

We heard David Walker talk earlier about an accrual budget or deficit estimate that he came up with in the $700 billion range. I think we all lulled ourselves into overconfidence when we have foisted on the CBO unrealistic guidelines.

That is one proposal. Another is, is there any possible way to quantify the cost of delaying, tackling these giant problems like Social Security and Medicare? And then perhaps allocating that for every Member of Congress and Senator so that we feel a personal responsibility, because as I understand it, it is not just interest costs that are accumulating. There are other more fundamental risks to the stability of our Nation, and that is not overstating it.

Michael Mandelbaum has just came out with a book called the Case for Goliath, in which he says the greatest risk we face isn't so much China or a resurgent Russia, it is our own Medicare program, and here is one of the leading foreign policy experts saying we are at risk of internal decay.

And our chairman is not here. He is running for Governor of Iowa, and that is fine. But look at the membership, you know, and I was here at the start of the hearing too, there were barely more members here then. We are barely giving our budget a lick and a promise. We passed last year's budget, the Senate conference report, in 2 hours from receipt from the Senate to final passage on the floor of the House. There are not three members of this committee who knew what was in it. We are doing a disservice to the people of our Nation when we behave this way.

And I want to be polite and nice and friendly and everything, but—and I am willing to fault both parties. But the hour is late for us to work together to save our country.

So thank you for carrying your important message. I am willing to hear any comments that you might have.

Mr. WALKER. First, there are three reasons that the number goes up every second of every day. We are continuing to run deficits, demographics are working against us, and interests costs are compounding. But to give you a sense, the total liabilities in unfunded commitments that I referred to earlier, $46.4 trillion, they went up a little over $3 trillion in the last year.

Mr. COOPER. So I could divide it out by day.

Mr. WALKER. It is a big number.

Mr. COOPER. Every member of this—certainly this committee certainly should feel that urgency, and then we should communicate that to our colleagues and then to the folks back home. And that task, that essential task, is simply not being done.

Mr. WALKER. By the way, $3 trillion is more than the proposed budget for next year.

Mr. CRENSHAW. Thank you.

Mr. Hensarling.

Mr. HENSARLING. Thank you, Mr. Chairman. Let me start out with some apologies to our panel. One, I understand I am the last thing standing between you and daylight. Second of all, I was tardy to the proceedings today, so we may have to replow some old ground, but I, not unlike my colleague on the other side of the aisle, was attending a meeting on this particular subject.

Let me hearken bark to a line of questioning that my colleague from New Jersey had. I have noticed that in these budget debates, that although the numbers change a lot of the rhetoric and debate points do not change. So clearly one of the things we hear from folks on the other side of the aisle is that really all the fiscal challenges we are facing today is as a result of tax relief that has been enacted under the Bush administration.

If that were true, and ignoring the fact that we have more tax revenues today than we had prior to that tax relief, but using static analysis, even if we let all of these tax provisions expire, Mr. Walker, if I have this right, I am looking at page 9 of your testimony, and I am just eyeballing this here, I think you have a model that shows the tax relief provisions expiring, and just eyeballing it, and am I seeing that maybe spending in one generation would increase from roughly 20 percent of GDP to almost 30 percent of GDP?

Mr. WALKER. That is correct. In other words, that won't solve the problem and it is not the only reason that we are where we are. Even when we had surpluses, we knew we were going to face large and growing structural deficits in the outyears due to known demographic trends and rising health care costs.

Mr. HENSARLING. What would it take to grow our way out of this dilemma?

Mr. WALKER. It would take economic growth rates that we have never seen before in the history of our country. I think one of the numbers I heard was double-digit real GDP growth every year for a long time.

Mr. HENSARLING. Again assuming that we allow the tax relief provisions to expire, in one generation if we don't reform entitlement spending, give me the—I guess it was Yogi Berra who once said when you find a fork in the road take it. I am not sure we want to take this fork in the road, but if we don't reform this entitlement spending and if we can't grow our way out, then we are looking at either some type of tax increases or cutting the rest of government.

Of what magnitude would the tax increase be at 2040 to solve the problem and bring us into balance? Do you know?

Mr. WALKER. Looking at this graphic (Figure 3), by 2040 you would have to increase Federal taxes alone more than two times compared to what they are.

Mr. HENSARLING. This particular chart, though, this assumes that tax relief is made permanent, correct? I was looking at your figure 3 as opposed to your figure 4.

Mr. WALKER. The tax relief is extended and made permanent, that is correct. It does assume that. That is correct.

Mr. HENSARLING. Well, if we could go to your figure——

Mr. WALKER. To go back to the other one?

Mr. HENSARLING. Yes.

Mr. WALKER. Go back to the old one.

Mr. HENSARLING. Figure 3, I am trying to see what type of magnitude of tax increase would be necessary on the next generation to balance the budget.

Mr. WALKER. Under this scenario you are talking about by 2040 the Federal tax increase would have to be to more than twice today's level.

Mr. HENSARLING. Ms. Sawhill, I don't wish to put words into your mouth, but I caught a part of your testimony. Let me see if I have captured it fairly. I believe I heard you say something along the lines when it comes to entitlement spending, not unlike Nixon going to China, that ultimately the Democrats are going to have to lead and reform entitlement spending. Is that a fair assessment of what you said? What did you say? Can you repeat it for me?

Ms. SAWHILL. I said something along those lines. My point was that it is not going to happen unless Democrats are comfortable with what is done, and Democrats aren't going to be comfortable with this unless revenues are also on the table. I mean that is obvious, it seems to me.

And we I think are not seeing the kind of structural reforms we have all been talking about because the political system is not, for various reasons, producing the kind of compromises and the kind of bipartisan work that is needed.

Mr. HENSARLING. Thank you. Mr. Walker, did you have a comment on that?

Mr. WALKER. I just want to clarify one point if I can. If none of the tax cuts are extended, and all of them are allowed to expire, then even under that scenario, under this long-term simulation, you would have to increase Federal taxes in 2040 by about 50 percent.

Mr. HENSARLING. Thank you. With that my time is up, and I appreciate your testimony.

Mr. CRENSHAW. Well, I think it was——

Ms. SAWHILL. Can I add something on that?

Mr. CRENSHAW. Certainly.

Ms. SAWHILL. I think it is important to understand here that, you know, you pick a particular year, and then you get a mechanical almost increase in taxes. It is going to be required to fill the gap in that particular year. But what is happening by the time you get out to 2040, 2050, in these outyears, is the whole process becomes explosive. There is no tax increase that would do the job because the debt begins to feed on itself. So we are never going to get there. It is kind of hypothetical.

Mr. WALKER. By the way, the model that we run in that second scenario blows up between 2040 and 2045.

I mean, in other words, it is a meltdown scenario. You can't allow that to happen.

Mr. CRENSHAW. Well, thank you all very much. I think Yogi Berra also said that it is hard to make predictions especially when they involve the future, but I think the predictions that you make certainly are very clear to all of us and they are relatively grim in terms of where we are heading, and so we thank you for kind of bringing that news to us.

We recognize how difficult some of these reforms are going to be, but we need to hear it from objective folks like you all that kind of cut through all the politics to say we have got a real problem on our hands, and so we thank you for that message and we thank the members for their attention today. Thank you so much.

[Whereupon, at 4:15 p.m., the committee was adjourned.]

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